H.R. 3703—THE HOUSING FINANCE REGULATORY IMPROVEMENT ACT—PART 1

HEARINGS

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, SECURITIES AND
GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON BANKING AND
FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED SIXTH CONGRESS

SECOND SESSION

MARCH 22; MAY 16, 2000

Printed for the use of the Committee on Banking and Financial Services

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WITNESSES

TUESDAY, MAY 16, 2000

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

H.R. 3703—THE HOUSING FINANCE REGULATORY IMPROVEMENT ACT—PART 1

WEDNESDAY, MARCH 22, 2000

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES,
AND GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON BANKING AND FINANCIAL SERVICES,
Washington, DC.

The subcommittee met, pursuant to call, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Richard H. Baker, [chairman of the subcommittee], presiding.

Present: Chairman Baker; Representatives Leach (ex officio), Lucas, Jones, Ryan, Sweeney, Biggert, Terry, Roukema, Cook, Riley, Kanjorski, Velázquez, Bentsen, Weygand, Waters, C. Maloney of New York, J. Maloney of Connecticut, Hooley, Jones, Capuano, Hill, and Vento.

Chairman BAKER. I would like to call the Subcommittee on Capital Markets of the House Banking Committee to order. The purpose of our hearing today is to receive testimony from regulators of the Government Sponsored Enterprises and to consider the implications of H.R. 3703, legislation introduced intended to enact a new regulatory format for Government Sponsored Enterprises. I think it appropriate at the outset to set the circumstance in which this hearing will be conducted, at least from my perspective.

It is not held with a belief that the current financial condition of Government Sponsored Enterprises is in any way in jeopardy. They have enjoyed tremendous economic opportunity over the last decade. All are well funded, all are well managed, and all operate very successfully in today's marketplace. This hearing is not an attack on Government Sponsored Enterprises. I believe that if they conform to the mission statement in their charter, they provide a valuable public service.

It is not an effort to create or enact an unwarranted, unneeded, complicated regulatory scheme. It is, however, an effort to insure there is competent regulation on the activities of these enormous and extremely complex entities. I would point out that in 1992, the Congress acted with the creation of the office of OFHEO and required that entity to construct a stress test for the sole purpose of determining capital adequacy of these enterprises.

Regrettably, as we meet here today eight years later, that stress test has not yet been implemented. My understanding is that one GSE has actually asked for a two-year extension to consider the potential implications of the implementation of that stress test. I am still learning a great deal about the GSEs, but know the basics

about finance. Whenever I go in for a loan, the bank examines my personal statement, my collateral, makes a very difficult decision and then, at some future point, extends the credit, but capital and financial condition come first.

I find the GSE circumstance to be just the opposite. Since 1992, when we said as a Congress "establish a method to identify and establish if capital adequacy is there," over $2 trillion of debt has been extended by the GSEs as we are here today, and we still cannot objectively determine whether by regulator analysis whether the GSEs are adequately capitalized. That is unacceptable. This hearing will be followed by others. There will be no intent to rush to judgment. I certainly hope that there will be constructive suggestions to follow from all interested parties as to how this can best be constructed and certainly understand that our modest proposal can be perfected in a number of ways.

I am particularly pleased this morning that the Chairman of the full committee, Jim Leach, has joined us and I would like to recognize the Chairman at this time for any remarks he would like to make.

[The prepared statement of Hon. Richard H. Baker can be found on page 138 in the appendix.]

Mr. LEACH. Thank you, Mr. Chairman. I think your hearing outline is very thoughtful. These are issues that Congress has an obligation to review on a continual basis. We set up the housing GSEs for a public purpose. They have served the purpose, in many regards, very well, but one of the real questions we all have to think through is what are the rules at any given point in time. And there are issues of stress tests that this subcommittee should review.

There are also issues of competitive advantages in the marketplace even if one accepts the stress test that has been put on the table, because even with that stress test, the housing GSEs can leverage capital more than their competitors. This gives them an enormous competitive advantage in the marketplace on leveraged capital, as well as on the simple fact that they can, particularly at given points in time, purchase capital for less than their competitors.

Issues have been raised, as the Chairman well knows, about the role of these GSEs and the total debt that they are issuing relative to Treasury bills. The Chairman has indicated and set out charts showing that at a possible point in time in the next three or four years, there will be more housing GSE debt than Treasury debt. But I would like to stress a second issue and that is that competitors of GSEs—commercial banks—are now holding, on the average, housing GSE securities almost equal to their capital.

And that means, if you think of the too-big-to-fail doctrine, that if one of these GSEs fails, the Government is in an awkward position that will have a gigantic rippling effect on the banking system. This is another reason why prudential levels of capital have to be looked at very carefully. Now we are all fortunate as a society that these are well-run institutions. If they were not well run, we would be in a real pickle. And so we have to congratulate the leadership of both of these GSEs.

And, finally, I would just conclude by saying that one of the lessons in the last decade appears to be that the powers that these

institutions have been given, coupled with the excellent management of the institutions, means that if they expand their authorities beyond the housing area, they have advantages in those areas. That raises the whole question of mission and that is something that I am pleased that your subcommittee has decided to look at carefully.

Anyway, I want to thank you for your very thoughtful leadership. Whether one agrees or not from any Member's perspective with conclusions that you have drawn in the bill that I co-sponsored with you, the fact is as a committee these are issues that just demand review, and frankly, on a continual basis. Thank you, sir.

Chairman BAKER. Thank you very much, Mr. Chairman. I do very much appreciate your willingness to co-sponsor the measure and would also point out that Senator Phil Gramm, the Chairman of the Senate Banking Committee, has commented that this is just a modest first step, but in only the way that Senator Gramm can say it. We are stumbling along over here trying to get it right, and I think we look forward to working with the Senator as well on his areas of concern and coming to some conclusions in this, but thank you for your interest and your support.

Mr. Kanjorski.

Mr. KANJORKSI. Mr. Chairman, thank you for the opportunity to speak briefly about H.R. 3703, the Housing Finance Regulatory Improvement Act, the subject of today's hearing. Let me begin my remarks by once again commending the Chairman for his leadership. In H.R. 3703, he has developed a legislative proposal certain to provoke considerable public debate about the future regulation of the housing Government Sponsored Enterprises, or GSEs.

He has also focused our subcommittee in recent years on a number of public policy issues affecting the operations of GSEs. Last year, for example, I worked closely with him to finally enact legislation to reform the operations and mission of the Federal Home Loan Bank System. Additionally, as a result of the Chairman's initiative, our subcommittee held several hearings in the 105th Congress on the effectiveness of the Office of Federal Housing Enterprise Oversight, the Department of Housing and Urban Development, and the Federal Housing Finance Board in pursuing their respective mission compliance oversight and safety and soundness supervision objectives.

The Chairman also requested and received a series of reports from the General Accounting Office about the operations of the current GSE regulators. Then, after building a substantial legislative history about the performance of the GSE supervisors, the Chairman introduced H.R. 3703 in the 106th Congress, a bill designed, among other things, to create a single overseer for the housing GSEs.

From my perspective, we need to have strong, independent regulators that have the resources they need to get the job done. Moreover, as one of the few remaining Members of the subcommittee who experienced the Congressional battle to resolve the savings and loan crisis, I am acutely aware of the need to protect taxpayers from risk. It is in the public's interest that we maintain a strong regulatory regime over Fannie Mae, Freddie Mac, and the Federal

Home Loan Banks. I am, therefore, pleased that our current GSE regulators are operating increasingly more effectively.

Additionally, our Nation's current system for housing finance is not only extremely successful, but it is also the envy of the world. Almost 67 percent of Americans own the homes in which they live. This success, however, should not stop us from asking whether and how we can do a better job of increasing home ownership rates. We should always examine ways by which we can lower mortgage rates and improve regulatory efficiency.

That said, we should move forward cautiously in this area. The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 is only now beginning to produce its intended results. By the end of this year, OFHEO hopes to finalize its dynamic risk-based capital standard for Fannie Mae and Freddie Mac. That rule will further help to protect taxpayers against systemic risk. HUD will also complete its work on updating the affordable housing goals for the two enterprises. These goals, as I understand, will force the GSEs to aggressively increase lending in underserved areas. Finally, the Finance Board is developing the many regulatory changes needed to implement the Federal Home Loan Bank Modernization Act of 1999. The creation of a single regulator at this time could delay all of these important activities. Furthermore, pursuing significant legislative changes could upset the housing finance marketplace. Fannie Mae, Freddie Mac, and the Federal Home Loan Banks all help to lower mortgage rates for consumers. We must work to ensure that our work does not raise those costs for consumers or inappropriately discourage investors.

In closing, I hope that we are not on a fast track toward marking up this legislation. There is no pressing need for reform at this time. We should, however, carefully, deliberately, and objectively proceed in examining the public policy issues related to the mission compliance and safety and soundness regulation of GSEs. I look forward to debating the merits of this legislation.

Mr. Chairman, as an aside, over the last several days I have met with many of the representatives of the various interests affected by this legislation. Because of the complicated nature of these relationships, I urge the Chairman to consider holding hearings in a different mode, such as a round table discussion, or perhaps a debate, where the various entities could come in and debate some of the issues that we are going to have to resolve.

And I think that would have two salutary effects. One, it would clearly inform a large portion of the Membership of this committee who have not gone through these issues before. Two, it would give us on a real time basis the opportunity to have issues proposed and then a response quickly proferred. That way, we could really cut to the chase of the matter. So I would urge in future hearings that we think about broad round table discussions where all the interested parties are brought to bear and have an open debate on the issue.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 146 in the appendix.]

Chairman BAKER. Thank you, Mr. Kanjorski.

First, to comment about your work with me on Home Loan Bank. Together we worked about a decade to go from the starting blocks

to the finish line. The point is we finally made it, although I hope our clock doesn't run quite that long. I am confident together we will make the finish line on this one. I would welcome comment from all parties. In fact, having encouraged the GSEs and all interested groups to give written comment about their perspectives on the legislation and renew that this morning and certainly will consider every possible method to get information before the Members.

You are very correct. This is complicated business. It is very important business. And we do not wish to do anything that adversely impacts housing markets. I would restate the obvious though. Somebody needs to stand between the taxpayer and the debt if things don't continue to work as well as they are and that is an extraordinarily large potential liability. I share your view of the 1980's, having come from one of the States that was unfortunately one of the most hard hit by that series of events and would remind the gentleman we do not wish to revisit those days for lack of regulatory oversight, and I know he shares that view.

Mr. Sweeney.

Mr. SWEENEY. Thank you, Mr. Chairman. I would like to see unanimous consent to revise——

Chairman BAKER. Without objection.

Mr. SWEENEY. And I will submit a formal statement. As a relatively new Member and understanding the complexities of the issues attended here, let me just say that I am thankful that you are having this hearing, because I think it is absolutely proper and correct that this subcommittee engage in the oversight of the housing GSEs. I also will operate under a couple of premises while keeping an open mind. Before we agree to do anything here I would like to be sure that we are not jumping to address problems that are not there; and second, any effort undertaken should encourage innovation and fair market competition. I congratulate you on holding these hearings and I look forward to participating.

[The prepared statement of Hon. John E. Sweeney can be found on page 148 in the appendix.]

Chairman BAKER. Thank you very much.

Mrs. Roukema.

Mrs. ROUKEMA. Thank you, Mr. Chairman. Again, I would ask unanimous consent to have my full statement in the record.

Chairman BAKER. Without objection.

Mrs. ROUKEMA. And I do want to extend congratulations to you for raising this very legitimate subject and it is worthy of examination by this subcommittee and by the full committee as already has been stated by a number of Members. I also want to acknowledge that the proposal certainly raises relevant questions about the three regulators. Consolidation of these regulators is something which must be carefully considered, as has already been very carefully pointed out by other Members here today.

But while the current system appears to cry out for regulator consolidation, I will acknowledge what the Chairman has already acknowledged and that is that we need to move slowly and carefully with full examination. First of all, as has been noted, I believe, the Gramm-Leach-Bliley Act has made significant changes to the statutory scheme for the GSEs and the Federal Home Loan banks. The changes in membership, capital and expanding collat-

eral that is eligible for advances were among the most important changes of that legislation.

And again while consolidating regulators might not appear to pose any risk, there is the question of unintended consequences, as I think several Members have all pointed out. I don't want to belabor that point, but we do really have to look at and have an examination of the real world experience of Gramm-Leach-Bliley and see whether or not we need to fix any of these unintended consequences before moving on to consolidation.

That having been said, however, I think we have mutual motivations here. I believe that we are all committed to doing the best and right thing without unintended consequences. There is a potential negative impact on the American dream of home ownership, as properly has been pointed out. I think all here recognize that we are at an all-time high in terms of home ownership. We want to continue building on that American dream. In considering doing what Mr. Baker is proposing here, we are faced with the question: if it isn't broke, don't fix it.

I think that is too simplistic. Many people have said that in addressing this question. I do think we can accept the fact that none of us want to do any harm. We will apply the "do no harm" principle to this. I am very happy, Mr. Chairman, that you have raised the issue. There are a lot of legitimate concerns as have already been outlined with respect to safety and soundness in capital standards and these are the things that we are initiating a long—well, if not a long, certainly an in-depth study with all relevant information before we move ahead here.

But you have made a good step—an excellent step, if not a giant step—perhaps one could say, in the right direction and opening up this legitimate subject. But again I expect this Congressional review process to be a thorough one and I hope I can say we will do no harm to the American dream of home ownership. Thank you very much, Mr. Chairman.

Chairman BAKER. Thank you, Chairwoman Roukema. I certainly appreciate your courtesies and continuing interest in this matter. Mr. Cook.

Mr. COOK. Thank you, Mr. Chairman. I would ask unanimous consent to have my full opening statement put into the record.

Chairman BAKER. Without objection.

Mr. COOK. I want to say we are particularly pleased that one of the important GSEs, Fannie Mae, has established a very important and new presence in my hometown, Salt Lake City. At the same time, I want to commend the Chairman for some thoughtful questions that are clearly being brought forth in this proposed legislation. I am most interested in getting the benefits of this hearing to know exactly what kinds of regulations are appropriate and necessary if that needs to be the case and I just want to commend you for holding these hearings.

[The prepared statement of Hon. Merrill Cook can be found on page 142 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Cook.

Mr. Hill.

Mr. HILL. Thank you, Mr. Chairman. And I would just like to echo the comments of other Members. We are living in the best of

times. Some people would say these are the good old days, a period of unprecedented prosperity. Home ownership is at record levels. To a great extent interest rates are at also record low levels. But I think this is an appropriate time to examine the risks and the regulatory framework for these GSEs and make sure that when the inevitable business cycle turns the other way we don't get caught not understanding what the risks were and what the situation was so I would commend the Chairman for holding the hearing and look forward to the testimony of the witnesses.

Chairman BAKER. Thank you very much, Mr. Hill.

Mr. Riley, did you want to make an opening statement?

Mr. RILEY. No.

Chairman BAKER. At this time I would like to recognize our first witness for the hearing today. And a special word of thanks. I know that special efforts were made to meet our schedule and for that I am grateful. The Under Secretary of Domestic Finance, Gary Gensler, who will give us his views with regard to the current GSE safety and soundness issues. Thank you and welcome.

STATEMENT OF HON. GARY GENSLER, UNDER SECRETARY FOR DOMESTIC FINANCE, DEPARTMENT OF THE TREASURY

Mr. GENSLER. Mr. Chairman, Representative Kanjorski, Chairman Leach, and Members of the subcommittee, I appreciate the opportunity to testify on the supervision and regulation of Government Sponsored Enterprises. My prepared remarks are divided into four parts. First, a little background on GSEs. Second, GSEs' role in the capital markets. Third, a general approach the Treasury has taken to mitigating systemic risk. And then, fourth, turning my thoughts to the Administration's views on the bill.

With your permission, Mr. Chairman, I would like to submit my full written remarks for the record, but summarize it, if that would be all right.

Chairman BAKER. Certainly. Without objection.

Mr. GENSLER. The Nation's interest in a vital housing market is strong, and the three housing GSEs have done much for home ownership in this country. Our capital markets are the most competitive and efficient in the world and generally operate without the Government providing differential treatment among financial institutions. Government Sponsored Enterprises are an exception to this general approach. The Government provides them with benefits to affect market outcomes.

The potential benefits they bring to the particular market must be balanced, therefore, against potential systemic risk and effects on market competition. And reconsideration of this balance is appropriate from time to time as financial conditions change. With no particular problems on the horizon this is an ideal time to review the status of GSEs. The Federal Government initially created GSEs to provide credit to illiquid thrifts and to provide assistance to the secondary market for mortgages.

Much has changed, however, since this early history. Our capital markets have developed increasingly sophisticated techniques and tools for financing mortgages. Today, the GSEs are large, sophisticated financial institutions. Similar to other financial institutions, they hold and manage risk. They are owned by the private sector.

They have large balance sheets and are leveraged. And in these ways the GSEs are very similar to other large financial institutions.

The GSEs' growth has been aided by numerous benefits derived from their Federal charter. Congressional Budget Office, GAO, and the Treasury have consistently identified three advantages provided to the GSEs.

First, the GSEs continually operate with significant funding advantages over other private companies in equal or better financial condition. While various estimates vary on this, my written testimony shows benefits of between 20 and 40 basis points.

Second the GSEs operate with less equity capital per dollar of debt than other financial institutions. On average the two, Fannie and Freddie, have about $32 of debt for any dollar of equity capital and the Home Loan Banks have about $19 of debt per dollar of equity capital. This compares to other financial institutions where banks and thrifts tend to have about $11 or $12 of debt per dollar of equity and securities firms that are more highly levered at about $25 of debt per dollar of equity capital.

Third, the GSEs receive direct cost savings as a result of exemptions from SEC registration fees and State and local taxes.

These advantages are significant in the marketplace in which the GSEs operate. And, again, the U.S. capital markets are the most competitive and efficient in the world. Relatively small advantages, even measured in single basis points, can allow firms to earn higher returns and potentially dominate their markets.

The GSEs now control a central position in the mortgage market and an increasing share of U.S. debt markets. The three housing GSEs' debt was $1.4 trillion at the end of last year. This is large on any relative scale. It is roughly the size of the entire municipal bond market, which includes the debt of all 50 States and all localities in this country. It is now more than half of the $2.7 trillion of outstanding, privately-held marketable Treasury debt.

If one added the $1.2 trillion of GSE guaranteed mortgage backed securities, GSE's involvement in the credit market approach is the size of the Treasury market. Based on recent trends and growth forecasts of the companies, GSE debt is likely to double in the next five years, approaching $3 trillion by 2005. This would surpass the Treasury debt market some time in the next three or so years.

The GSEs have become the dominant institutions in the secondary mortgage market. As of year end 1999, Fannie Mae and Freddie Mac owned or guaranteed roughly 63 percent of all outstanding conforming conventional mortgages. GSE debt is also a significant portion of banking assets. As of mid-1999, banks held over $200 billion of GSE debt and also had approximately $350 billion of mortgage-backed securities guaranteed by those GSEs.

Banks' holdings of GSE debt represent over one-third of their total capital. While banks are not permitted to hold more than 10 percent of their capital in any corporate bonds or not more than 15 percent lending to any one borrower, GSE debt is exempt from these various restrictions. And as you can see from the numbers, it is likely that many banks' exposure to any one GSE have that is beyond those limits. As the GSEs continue to grow, issues of po-

tential systemic risk and market competition become more relevant.

Treasury's general approach to mitigating systemic risk and capital markets emphasizes the role of the private sector. The public sector does have various roles. I would like to identify three that are consistent with long-standing Treasury views. First, we must create an environment in which market discipline can work effectively. Promoting market discipline means crafting Government policy so that creditors do not rely on Government intervention to safeguard them against loss.

Second, promoting the maximum degree of transparency, and, third, maintaining the competitiveness of the system itself. Promoting competition lessens systemic risk in any sector of the financial market, and the dominance of one or two firms can lessen competition and the efficiency of the market pricing mechanism.

Mr. Chairman, I appreciate your efforts to highlight these issues. I now turn in summary to the legislative proposal. H.R. 3703 promotes private market discipline by repealing the housing GSEs' conditional line of credit with the Treasury. The dollar amount of these lines of credits are now a mere fraction of the GSEs' actual borrowings. For example, since its line of credit was established at its current level in 1957, Fannie Mae's mortgage holdings have increased over 300 times.

Therefore, any function the lines of credit perform at this point is purely symbolic. Repealing the lines of credit would be consistent with the Congressional requirement that GSE securities clearly state that they are not obligations of the U.S. Government. The bill will also promote private market discipline by authorizing the appointment of a receiver to resolve a troubled institution, the same authority that other Federal regulators have, and by repealing the Home Loan Banks superlien authority.

The bill contains provisions that increase transparency, which we believe would increase the efficiency of markets. We also believe that the provision calling for the GSEs to be annually rated by an independent rating agency is an improvement over current law.

The bill contains provisions promoting market competition as well. Limiting new activities of GSEs could limit their scale, increase their focus on mission-related activities and decrease the risk exposure.

The bill also highlights an important issue, the potential for problems at one financial institution to cause instability in markets or to cause problems for other institutions. As I noted earlier, GSE debt obligations are exempt from the banks' investment security limits or banks' loan to one borrower limits. We believe that Congress should seriously consider the best way to repeal such exceptions with sufficient transition periods to prevent any market disruption.

The bill also addresses the regulatory structure for the GSEs. We believe that the standard for regulation and the tools available to the regulator are issues of primary importance. But the identity of the regulator is important as well. And we agree with you, Mr. Chairman, that it may be appropriate to have common regulators for the three housing GSEs. We also believe that the supervision of the GSEs should be the duty of the Executive Branch of Govern-

ment, which is charged with economic policy, both banking and housing policy.

Responsibility for regulating financial condition could be placed with an agency responsive to those in the Executive Branch who oversee the soundness of the financial system. Experts in housing could supervise mission.

Mr. Chairman, if I may conclude, the economy and the financial markets are strong. The GSEs play a central role in the Nation's housing and debt markets. With no particular problems on the horizon, this is an ideal time to review the supervision and regulation of the GSEs.

Thus, your subcommittee is providing a valuable service by thinking through the best framework for overseeing these enterprises. These are important matters of public policy that require balanced, thoughtful review by all interested parties.

[The prepared statement of Hon. Gary Gensler can be found on page 151 in the appendix.]

Chairman BAKER. Thank you, Mr. Secretary. I really appreciate your testimony. Mr. Kanjorski and I will make sure every Member gets the summary of your observations. I think anyone listening understanding the scope of obligations the GSEs now represent in the current financial market and fully understanding our current regulatory capacity, would have to have some concerns, not about today, but about tomorrow. Some have characterized H.R. 3703 as a "solution looking for a problem" or "if it isn't broke, don't fix it" approach.

I would like to respond to those observations with this question. What was the financial condition of Fannie Mae from 1979 to 1984?

Mr. GENSLER. Mr. Chairman, as I said in my written testimony, there was a time in the early 1980's when Fannie Mae found, based upon movements in interest rates, that on a mark-to-market basis they were insolvent. Again at this point in time we don't see particular problems on the horizon, but we do think it is appropriate to consider the balance of public benefits that these GSEs provide to the market and at the same time consider the risk to the financial system as a whole.

Chairman BAKER. I share that view exactly. I was merely pointing out that to understand the future one must look at the past. It is not something that is impossible nor altogether improbable and to act without some concern about future business cycles is, in my view, somewhat irresponsible. Looking to the future, we have a chart to your right, Mr. Secretary, which describes in graphic form what you said in your testimony with regard to the potential future GSE debt growth as opposed to the publicly-held Treasury debt.

I think your testimony was a bit more progressive than our chart as it turned out. I think you indicated that it would be about 2003 when the GSE debt would surpass that of the Treasury. If you were to make some very large assumptions and that you were Secretary of the Treasury five years from this date and you were sitting in this committee room responding to questions from some troublemaking Congressman and look at these numbers that are represented by that chart where GSE debt would have not only

surpassed, but exceeded Treasury debt by significant measure, would that be cause for concern given current regulatory constraints?

Mr. GENSLER. I think that the chart that you have, which compares housing GSE debt versus publicly-held Treasury debt and includes some forecast into the future, is illustrative of the central role that the GSEs have come to be not only in the housing finance market, but in the debt market as a whole. And with the very good fortune of the economy and the fiscal discipline that this Administration and this Congress has been able to share, the Treasury debt is declining.

On the chart I presume, I can't see the small print, that it is based on our publicly-disclosed——

Chairman BAKER. That is correct.

Mr. GENSLER. ——Administration's forecast, publicly-held debt today is about $3.6 trillion and would be declining along that path. I was referring in my testimony to privately-held marketable debt, which we do not forecast publicly. Privately-held marketable debt does not include debt that is also held as savings bonds that is not marketable and is held by the Federal Reserve. So in my testimony, I was referring to the about $2.7 trillion in privately-held marketable debt and what might likely occur, which is why GSE debt would cross that line maybe a year or so before.

But I think this is an illustration of the central role that these GSEs may come to be and why it is appropriate from time to time for this subcommittee to look at their supervision and regulation. It is also why we look at certain aspects of your bill in the context of how to mitigate systemic risk. We think it is appropriate to look at ways to mitigate that risk by promoting private market discipline, promoting transparency, and promoting competition.

Chairman BAKER. Thank you. Another question with regard to potential systemic risk relating to loans to one borrower. As I understand it today, a bank cannot extend to one individual or corporation credit which exceeds 15 percent of capital and that in some instances there are financial institutions, credit unions, for example, with old agency paper as part of their tier one capital in the case of a bank. I am told that there are financial institutions of which in excess of 70 percent of that portfolio is agency debt, that there are significant numbers of institutions, perhaps as many as 30 or 40 percent, which have over half of that portfolio in agency debt.

How do we reconcile the concerns that regulators must have had when the 15 percent loan to one borrower limit was set as against the GSE's ability without constraint to occupy that level of concentration in a bank portfolio? Isn't that a terrible oversight on our part?

Mr. GENSLER. Mr. Chairman, I think you have done a valuable service to highlight this issue in your bill. We think that in promoting private market discipline it would be appropriate with sufficient transition periods so not to disrupt markets, to repeal these exemptions. These limits were put in place to promote the safety and soundness of the banking system, there are various limits, but 15 percent loan to one borrower limit is for the banks.

And we think it would be appropriate as there are numerous banks and credit unions, even though we don't have as good statistics on the credit unions, that do hold in excess of that 15 percent limit, and there may be some, as you say, that hold as much as—I think your number was 70 percent—of their capital in GSE debt.

Chairman BAKER. One last question, because I am already well over my time. Can you tell me this morning that the United States Government does not extend its full faith and credit to GSE debt?

Mr. GENSLER. I think that Congress has actually stated that GSE debt is not guaranteed by the U.S. Government and such a statement is actually contained in the prospectus and on the face of the debentures of all GSE debt.

Chairman BAKER. If we were concerned about the failure of LTCM and systemic risk, which caused the intervention of the Fed some months ago, am I to believe that if we had an agency difficulty that would not be a similar response?

Mr. GENSLER. I think from Treasury's consistent philosophy, we think it is best to promote private market discipline, and that private market discipline means that investors and creditors should not only bear the fruits of their investments, but also bear the risk of those investments. And Government policy should be crafted in such a way that private creditors do not come to believe that the Government would in any way bear for them the losses that they may take from their decisions in the private markets.

These are private sector firms and we look at this consistent with other financial institutions.

Chairman BAKER. I appreciate your testimony and all your courtesy. Thank you.

Mr. KANJORSKI. The market for GSE paper is rather, I think, secure, relative to the unsecured paper market. If we were to discourage further debt in mortgage lending by the GSEs, where would that investment money flow? Is it going to purchase back Government securities, in your opinion? Would you rather see it flow to credit card notes as opposed to mortgage money?

Mr. GENSLER. Congressman, I think you are absolutely right. Part of that chart, the Treasury debt line is very much good news. It represents the shared view of the Administration and Congress that contributing to net national savings and preparing for our future by paying down the debt is very positive for the economy. The GSEs contribute to a very strong housing finance market and we share your view that it is important for that finance to continue and the markets to be strong.

I think that this chart is just highlighting that over time the GSEs may come to be even more central to the capital markets.

Mr. KANJORSKI. Mr. Secretary, the point I am trying to make is that eventually if we carry that line out, we hope that around 2013, if the President's projections are correct, there will be no publicly-held Treasury debt. So at that point, all other debts are going to look like they are terribly expansive. But on the other hand, if we apply the formula that if the market is held relatively tight in its growth potential from this point on to 2013, actually before that, 2008, the domestic product of the United States would double, and the amount of money available for securities is going to more than double, so these funds are going to have to flow somewhere.

The question is whether we are leaning towards hysteria when shown two lines, one coming down, and the other one going up, and not realizing that the policy discussions that we have to have here is where would the preference of the country and public policy be as to the placement of funds available in the marketplace? How much can flow into venture capital? What can go into product and investment? What can go into consumer credit? I for one, if given the choice of increasing my credit line and being sure that the consumer credit will be similar at the GSE line, I would prefer to take the GSE line over the consumer credit.

Mr. GENSLER. I think that it is a very positive step in paying down the Treasury debt and that will free up money and credit for all sectors of the economy. Our general approach is really that the private sector is best to price and allocate that capital and certainly Congress has noted with regard to the GSEs that it is appropriate to have Government sponsored enterprises to facilitate credit in the housing markets and the housing GSEs have contributed significantly to the housing markets. I share your view that it deserves thoughtful and balanced consideration over time as this discussion goes forward.

Mr. KANJORSKI. Concomitantly with that problem, of course, is the consumer debt, and a lot of consumer debt is being consolidated in equity loans. I just came from a bankruptcy course given at the Congressional Research Service, and heard some of the financing rearrangements being made of interest charges as high as 20 and 25 percent on home equity loans for lower-income people who are in financial difficulty. If the GSEs carry on with their process of maximizing home ownership, at what percentage point would you think is our maximum level of home ownership? And finally then, is there perhaps another method to discipline the private market as to prevent overcharging and allow support for home equity loans?

Mr. GENSLER. Administration policy has been that, again, it is best to promote private markets only where there is clear market failure, might it be appropriate to consider new activities for these GSEs or for even potentially new GSEs. And I think that is what Congress did when they created these GSEs many years ago, address clear market failure. We think there should be a high bar before moving to new activities beyond the ones already articulated in the charters.

Mr. KANJORSKI. So part of the undertaking of this subcommittee should be to re-examine all those underlying formulas as well as what products can be developed.

Mr. GENSLER. We think it is, from time to time, appropriate to look at the missions of any GSE so that they are focused, because it really is in a sense an exception to an overall philosophy we have in the capital markets and in this country of promoting the private sector. While recognizing that the GSEs have a mission, we think it is appropriate for Congress to look at it from time to time and to have a regulatory function that allows innovation on a real time basis. We think it is important these firms be able to innovate and be flexible with regard to their mission, and we share that view, because I think they have provided a great service there.

But, also, from time to time, look at assessing "is this mission the appropriate mission?", or, as you suggest, maybe possibly broadening it, or maybe doing something in the other direction. But that is really for Congress to decide.

Mr. KANJORSKI. There were proposals. Regarding one of my earlier questions on the interest rate for refinancing packages, sometimes I think just getting users 20 or 25 percent. Does the Administration have any policy as to whether we should re-examine the Bush-D'Amato proposal of limitation of interest rate at some point in the future if unfeddered activity in the market occurs? I mean, there is an abundant sum of money out there and if we limit GSEs from concentrating on the housing market, that money will flow somewhere and it could very easily start channeling itself into consumer debt, particularly opening up the underserved market. The least-able to sustain that level of debt in our society will experience extremely high rates.

I suspect anyone will lend money if the interest rate is high enough. Are we getting ourselves into a control mindset where Congress is going to have to start dictating limitations? And should we?

Mr. GENSLER. I think in terms of access to capital, we think our economy is strong, but we should always be focused to make sure that all Americans are able to access the capital markets or access the banking system. We have done much in the Administration to try to broaden access and information. And I would also say competition, and as you have noted, sometimes the low-income or moderate-income Americans don't have that same access, but if we can promote access to the banking system and access to competitive capital markets, that would be a very good thing to move forward.

Chairman BAKER. Thank you, Mr. Kanjorski. Just to clarify, I am not concerned about the fantastic enhancements in housing markets. As Capital Markets Chairman, I am only worried about concentration of assets in one industry and concentration of investments by banks. If you took GSE off that chart and put the word "Microsoft" or put "Chase" or put "IBM" and you saw the amount of dollars held by that institution. I remember persuasive arguments made by the gentleman and others about how big banks are going to run everything in the United States if we do this modernization proposal in some form or fashion.

And my point here is that we do not have the regulatory competency, in my view today, to fully comprehend their market risk and that is all that this is in pursuit of. I don't want the GSEs nor anyone else to take this hearing as what they are doing is bad or they are doing it poorly. That is not it at all. This is a forward look down the road and do we have the ability if that chart comes to reality to understand our exposure, and I honestly don't think we are there.

Why don't we recognize Mr. Sweeney. We will have him for his comments and then we will recess for the vote and come back.

Mr. Sweeney.

Mr. SWEENEY. Thank you, Mr. Chairman. I will have a very brief question in an attempt as a new Member of this subcommittee to try to understand better capital markets. In boiling this issue down, Mr. Secretary, the question is what are the risks and do they

rise to the level that we need to act? In light of that, and in light of Mr. Baker's point that some institutions hold agency debt as over half of their capital, could you play out a scenario for me reluctantly, as I guess you would be, on what those risks are and explain to me where the private sector risks are the greatest?

Mr. GENSLER. I think it would be best not to try to deal with a hypothetical, but what I think is all financial institutions, banks, security firms, insurance companies, GSEs, as part of their mandate in the private sector, seek to hold and manage risk. The GSEs do that and do that well, but still the nature of the financial system is that there is risk by the holding and managing of risk in financial institutions.

Our general approach to managing—or I am sorry, our general approach to mitigating risk, is to promote transparency, to promote market discipline, promote competition. It is only in that light, that general light, when these issues have been raised by Chairman Baker's bill, that we have looked at some of these issues and found some of the provisions of the bill we believe help promote transparency or help promote the private market discipline.

And while the economy is strong and housing finance is strong to take a thoughtful and balanced discussion of this at this time is appropriate as was done in years past in this subcommittee and may well be in years in the future.

Mr. SWEENEY. The economy is strong and stable at this point, but if we were to undergo market changes, specifically, market changes in interest rates, explain to me what you would foresee occurring within the GSEs and within the overall market.

Mr. GENSLER. I couldn't speculate on any one GSE, because it may not relate to interest rates rising or falling. These are very complex financial institutions as are banks and as are security firms. Very large sophisticated financial institutions are subject to a number of risks. Interest rate risk is one, as you have identified, credit risk is another. Something that is also true of large financial institutions is liquidity risk, the risk of when markets adjust, can you sell or buy your portfolio.

The history of markets has shown that there is also an intersection of these risks which relates to scale and liquidity. So for all financial institutions it is appropriate for regulators to look at how we mitigate some of those systemic risks through appropriate supervision and regulation.

Mr. SWEENEY. I thank you, Mr. Chairman. I will yield back my time knowing that we have to go to vote and I have to go to another meeting. I again thank you for the hearing.

Chairman BAKER. Thank you for your participation. The hearing will stand in recess pending the vote. We will return as quick as we can, Mr. Secretary.

[Recess.]

Chairman BAKER. When the hearing recessed, Mr. Sweeney had just completed his remarks and Mr. Weygand, you would be up next if you would like to be recognized for comment.

Mr. WEYGAND. Thank you, Mr. Chairman. I would like to ask the Secretary just a couple of brief questions more on philosophy and direction that was probably an echo of my colleague, Paul Kan-

jorski's, Mr. Secretary. The chart that you have provided us, the chart on our left, indicates a change in direction with regard to debt. I apologize for coming in late. We had a previous meeting, but is it your position that this is not the direction we should be going in philosophically with respect to the Treasury regarding our debt?

Mr. GENSLER. With regard to Treasury debt it is very much the philosophy of the Administration that we want to bring down Treasury debt, our national debt, and contribute to net national saving and contribute to the economy.

Mr. WEYGAND. And isn't it true that we have been working toward and talking about reducing the debt, not only Treasury debt, but overall Government debt, which provides more liquidity, more money in the marketplace for private investment in other ventures and that has been our goal. So isn't it philosophically the direction the Administration and most of us here have been taking anyway?

Mr. GENSLER. I think that it is very much the philosophy of this Administration and shared with the Congress that paying down the national debt contributes to the economy through freeing up, and as we might say crowding in the rest of the market. I think that the context of—this was actually the Chairman's chart—is just that we think that it is appropriate from time to time for Congress to look at the balance, the balance of promoting housing, which we do very well in this Nation, and the benefits that are given to the GSEs, the various statutory benefits.

That balance should consider on the other side issues of the risk to the financial system and issues of market competition. And it is best to do that when the economy is strong and when housing finance is strong. That is why we appreciate the opportunity to talk here today.

Mr. WEYGAND. I do not disagree with the concept of periodic review to see if the balance is proper, the diversity is proper, and that things are not going wrong, but isn't it true that our philosophy has been that by reducing the debt we allow for more money to be in the marketplace to be used for mortgages with regard to home improvement loans and a host of other things, so we therefore have encouraged this philosophy that is illustrated on the Chairman's chart?

Mr. GENSLER. We have encouraged the top line for sure, and in ways we have encouraged the bottom line, but I just noted in my testimony earlier there are various benefits, funding advantages and leverage advantages and cost advantages that the GSEs have. And in our capital markets they are so efficient that even modest advantages can allow financial institutions to come to dominate their markets, and I think that is just what is highlighted on the bottom line.

Mr. WEYGAND. Again, excuse me for not being here earlier, and I haven't read your full statement, but are you taking the position that the bill before us, H.R. 3703, is something that you are endorsing and promoting?

Mr. GENSLER. We have really looked at the bill in a context of Treasury's general philosophy of mitigating systemic risk, promoting transparency, promoting market discipline and competition. There are a number of aspects of the bill that we think help in that regard. We think it is appropriate for the subcommittee to have a

thoughtful review of this and really bring in all the parties who have an interest collectively of mitigating systemic risk.

Mr. WEYGAND. And, last, in today's situation, today's conditions, today's marketplace looking toward the future, five or ten years down the road, are the regulators currently overseeing GSEs doing an inappropriate job or do you feel that there are presently problems within the existing regulations that would warrant a more immediate change toward H.R. 3703, or should there just be an ongoing discussion of how we can best make sure the market is not only competitive, but also promptly secured?

Mr. GENSLER. I think that there is not a problem on the horizon, but I think because of the significant change in the scale, scope, and centrality of the GSEs to the capital markets, it is appropriate to assess the balance moving forward.

Mr. WEYGAND. And you think they, the GSEs, are getting too big and too central for your preference?

Mr. GENSLER. No. I just think that there are aspects of promoting the markets in the financial system that from time to time are appropriate to look at. We think that the Chairman's bill highlights a number of those that may be worthy to move forward on. Also, we do think that it is very important that the regulator should finalize the risk-based capital standards and get those out promptly.

Mr. WEYGAND. Thank you, Mr. Secretary.

Chairman BAKER. Thank you, Mr. Weygand.

Just to clarify on one of Mr. Weygand's questions and your response, this is not a trick question seeking an endorsement, but it is a clarification of points of concern. I recognize there may be concerns by HUD and others about the mechanism of the regulatory structure. Put that aside for the moment. Are there any other suggested aspects of H.R. 3703 that are a problem to Treasury at this point?

Mr. GENSLER. Mr. Chairman, we have identified in our testimony a number of attributes that we support, some that we think are worthy of further and serious consideration to help mitigate systemic risk. I think that in terms of the regulatory structure we share some of the attributes. We think that mission regulation could be best served by being within the aegis of the experts on housing, and the financial condition regulation could be under some other oversight. So I think with regard to that we do have some different thoughts. We did not actually catalog each and every aspect of the bill.

Chairman BAKER. Let me follow up to make it clear for Members. I will transmit to you a formal request recognizing that the HUD mission governance issue is not a subject of debate. We understand the position there. But on the regulatory safety and soundness aspects of the legislation, I will write and ask you for a response if there are any aspects of that with which Treasury has difficulty, and you will be prepared to respond to that.

Mr. GENSLER. As always, as Congressional requests come in, we respond to them. Absolutely.

Chairman BAKER. For the subcommittee's benefit, I want them to know that is on its way. Thank you.

I am going to try to do this in recognition of those who came first. Mrs. Roukema has been very patient here for most of the hearing and she would be next to be recognized.

Mrs. ROUKEMA. Thank you, Mr. Chairman. I appreciate that, but you just asked my question. You and I have been thinking about the same issues. I want to ask Mr. Gensler if he would be more specific in terms of his evaluation of this regulatory structure. It appeared to me that you neither support nor oppose this regulatory proposal. You rather talked around it.

I don't mean that you are trying to avoid the issues. We all recognize that there is a complexity to this. I would join Mr. Baker in submitting that question to you for a specific answer. Do you want to comment further now?

Mr. GENSLER. If I might. We believe the standard of regulation and the tools available to the regulator are issues of primary importance. The identity of the regulator is important as well. We focus much of our thoughts on the standard and the tools. With regard to the bill, we think that it may be appropriate to have a common regulator for the three GSEs, but have mission regulation led by those in the Executive Branch who are expert on housing and to have financial condition regulation, at least be responsive to those in the Executive Branch that have responsibilities with regard to the soundness of the financial system.

We look forward to any review of this. We think any review of this should be thoughtful and balanced and bring in all the interested parties. These are important broad matters of public policy, and we have tried to lay out broadly what we think on the combined regulator issue.

Mrs. ROUKEMA. Well, let us use your answer as the vehicle for further questioning. A little more amplification would be appreciated and would be the basis for our future inquiries and working together with Treasury on this subject. I have heard what you said about mitigating systemic risk. I certainly have recognized the importance of addressing systemic risk as well as recognize that there has to be promotion of competition, private market discipline, and increasing transparency. Can you spell out how do we do that in a couple of those areas?

Mr. GENSLER. The bill suggests in terms of transparency that we could call for having independent rating agencies annually rate the GSEs. We think that this could be an added benefit, not only to promote the private sector market discipline, but also to provide regulators with an independent view as to the financial condition of the GSEs. There are also various flexibilities built in to the bill with regard to making public disclosures with regard to the GSEs. We think that though——

Mrs. ROUKEMA. Are all these adequate or would you go further?

Mr. GENSLER. Well, in two cases we have actually have suggestions. One is with regard to what was earlier referred to as the banking system's exposure, credit exposure, to GSEs. It might be appropriate to work with Congress to have a sufficient transition period to find a way to bring the GSEs into the consistent scheme that we have for the banking system under those loan to one borrower and investment limits. Also, in a much smaller point, we have made a suggestion about bank exam fees.

Mrs. ROUKEMA. All right. Well, we will look forward to further in-depth discussions on these issues. As I said in my opening statement, and I repeat now, that safety and soundness and the mitigation of systemic risk is essential. We can't, however, be just talking in generalities. We have to be quite specific. I look forward to your specific comments. There are other questions that I might bring up at another time. Thank you.

Mr. WEYGAND. If the gentlelady would yield.

Mrs. ROUKEMA. I would be happy to yield.

Mr. WEYGAND. I would just like to follow up with the gentlelady from New Jersey's first questioning about detail and specificity regarding recommendations from the Treasury. I think it is extremely appropriate in this discussion that we are having about regulation. As I hear from you, Mr. Secretary, you are talking about a body that would actually oversee the development of mission. It would be that body who would oversee policy with regard to safety and soundness and then regulators.

This leaves a lot of unanswered questions about what you are actually telling us you would recommend with regard to H.R. 3703. I would truly hope that you could come back to us as quickly as possible with specific suggestions. If indeed you don't have a form or a structure that you would heartily endorse, but only a discussion about the possibilities, we would like you to be specific about those as well. It would be extremely helpful to us, because I think the Chairman is trying, in this legislation, to streamline or simplify the regulation, but what you have just outlined is indeed three different bodies or entities overseeing them all over again.

And that would be, I think, some concern to the Chairman. Not necessarily to me, but perhaps to the Chairman and I think we as a body should know what direction you are suggesting we follow.

Chairman BAKER. Thank you, Mrs. Roukema, for yielding to Mr. Weygand.

Mrs. ROUKEMA. Thank you, Mr. Chairman.

Chairman BAKER. I think Mr. Bentsen is next. I am not sure. I don't know the order of Members' arrival on the Democrat side. I will just proceed in order if that is OK unless somebody objects.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

Mr. Gensler, I have a couple of questions. I think, first of all, this is a rather broad bill that the Chairman has introduced and it raises a lot of questions. I don't think we can take this bill lightly at all. But I have some questions about your testimony. First of all, and I know this is just for comparison purposes, but I have got to tell you that I think the comparison of U.S. Treasury debt to the debt of the GSEs is really apples and oranges.

You are talking about debt that is used for operational purposes in terms of the U.S. Treasury debt. It certainly has been for the last eighteen or twenty years. And it is sovereign debt, as well, compared to debt that is used arguably for capital formation purposes in the acquisition of mortgages for portfolio purposes. And so I am not sure that there is a comparison there to be made. Now the question may be that you are trying to get at is have the GSEs just become too big, given all of the benefits that they have.

And that may be more where our topic should be, but I think this, and I know the Chairman has made this debate as well, I just think this is apples and oranges. And it may look good, but I don't think it is comparable. I think your comments with respect to equity to debt are reasonable, although the GSEs arguably have a different portfolio than banks would have. They have a different portfolio, because they are not carrying commercial loans in their portfolio and they have a different portfolio than securities firms would have, because they carry marketable securities, securities firms and marketable securities, as you know, some are more marketable than others given what is going on.

But I am particularly surprised by the Treasury's comment, and I think this is new, that you believe that we ought to repeal the line of credit that the GSEs have with the Treasury, and even though it is only a small amount, \$2 billion or \$2.5 billion compared to their overall capital, it seems to me that it is still a rather significant statement that the Treasury is making about that. I mean, in my mind, and I think you would agree with this, that is the whole essence of their AAA rating that they enjoy right now.

In the past, when this subcommittee has looked at it and when rating agencies have looked at it, I think we have come where Moody has finally said that they thought on their own Fannie and Freddie would have probably a AA-minus rating, which is not a terrible rating, but certainly a far cry from a AAA rating. And your own testimony says it is worth 30 to 40 basis points, I think, or certainly some spread there.

And you raise questions about the concentration of GSE debt held as assets by commercial banks and whether or not that is something that ought to be looked at as well. But at the same time that you are saying that there would certainly be some fallout if we were to repeal, in effect repeal Fannie and Freddie's market rating and that would put pressure on them and put pressure on banks that hold their bonds in their own portfolio.

So I think we need to think about this and I think that we really ought to let Mr. Falcon and OFHEO do their job and let us see what happens and then come back and look at this. So I don't really have a question for you, but I guess it is more of a comment, but I would hope we wouldn't move too fast and I would hope the Administration or the Treasury Department would not push too hard on the Chairman's legislation at this time until we see what OFHEO comes up with on their risk analysis that they are doing and then perhaps come back.

But I think also that Treasury might come back to us and tell us whether or not you think the GSEs have gotten too big and there is a need to completely restructure the secondary mortgage market. That is all I have, Mr. Chairman.

Chairman BAKER. I don't think I will ask you to co-sponsor it, but we will keep an open mind. The only thing I would like to point out on the chart, you are correct, it is apples and oranges, but the problem is the GSEs will make it apples and apples. As there is less Treasury debt for people to invest in, they have to have a place for liquidity and safety to park that money. It will either be Fannie benchmarks or Freddie reference notes.

And I can't tell you today, and I don't think anybody in this room can tell you with great certainty, that we have an objective criteria to assure taxpayers of the agency's financial adequacy. I am not suggesting there is a problem. I am just saying we don't have the tools to do that properly and that is what H.R. 3703 is about. So it is not to preclude that chart from happening. It is to make sure when it does you can tell your constituents you know what is going on. That is really what it is about.

Mr. Cook, you were next, I think, in arrival.

Mr. COOK. Thank you, Mr. Chairman. I want to thank Mr. Gensler for his informative testimony. And again looking at the chart of GSE debt versus Treasury debt and the fact that in just a couple of years it is going to probably be larger than Treasury debt and if we project that out to even 2010 it might be massively larger. And I would like to get your opinion as to whether GSE debt is going to replace Treasury bills and Treasury debt as the benchmark for investment in bond markets. And, if so, doesn't that really imply some need to really look at this whole regulatory question?

Mr. GENSLER. The U.S. financial markets are competitive, the most innovative of the world. We think that as Treasury debt declines it is very good for the economy as a whole, and it promotes many sectors of the economy as Congressman Kanjorski and others were mentioning earlier. We think that markets are innovative and will find a smooth transition to other referenced securities and derivatives. They have already done that to some regard.

And many other large corporate issuers beyond the GSEs are also assessing and looking to promote their securities as benchmarks. We believe the financial markets will sort that out in a smooth way over a long transition.

Mr. COOK. At the same time, I do think that one of the hazards of a whole lot of new regulation is the fact that each one of these GSEs is different. Freddie Mac is different than Fannie Mae and it is certainly different than the Federal Home Loan Bank in terms of the rules and even the purposes and the conditions and functions and so forth. And I guess what I am asking is if there needs to be significant and new regulation how do we take care of those differences? If you could comment on what the major differences the regulators would have to be concerned with in terms of those two or three major GSEs.

Mr. GENSLER. I think you raise a good point. We stated in the longer prepared remarks that we think that Congress has laid out different charters for particularly the Home Loan Bank System and the other two housing GSEs and if one were to move forward in consolidating or combining these regulators that it would be important for Congress to be very specific as to the mission of the various GSEs and to focus that mission on the intent of Congress.

The Home Loan Bank System pursues its mission more through lending to banks and thrifts and the other housing GSEs pursue their mission differently. And those distinctions, even if one brings together the regulators, may be appropriate to maintain as they have been in the past.

Mr. COOK. And then just kind of one final technical question. Is the Federal tax treatment both for corporations or individuals pret-

ty much the same in all the different GSE debts and compared to Treasury or what are the—if you could just maybe outline the significant difference, if any, between how they—a holder of the debt, how the tax—certainly Treasuries are not taxed at State levels and so forth. I just wonder does that apply also to the——

Mr. GENSLER. Let me make sure I get this technically right. I think this will answer the question. The interest on the bondholders Federal Home Loan Bank debt is tax exempt at the State and local level. That is not the case with the other GSEs.

Mr. COOK. I think more evidence of probably the difference in terms of regulations. Thank you.

Chairman BAKER. Thank you, Mr. Cook.

Ms. Waters.

Ms. WATERS. Thank you very much, Mr. Chairman. Let me perhaps ask some questions that may have been asked before, but I need a little bit of clarification. Are the GSEs sound? Are we faced with GSEs presenting a particular kind of risk that I don't understand? Would you describe for me or answer for me is there a problem with the GSEs in terms of their management at this time?

Mr. GENSLER. Congresswoman, we don't see a problem on the horizon. The economy is strong and the housing finance market is strong. These entities have, as we can note in the testimony, strong performance and strong growth, and they manage their risks as other financial institutions manage risks in a sophisticated manner. I think that all that we have noted in our testimony is that a lot has changed since 1992 when Congress last took these issues up in a broad legislative package.

Ms. WATERS. Before you go on, I just wanted to get that on the record and to have that understood. There is no problem and that they are managed well. As a matter of fact, since I have served on this subcommittee I have come to understand that they are admired, because of the way they have managed these GSEs and the way that they have been able to demonstrate that they can manage them well, they can provide the product, and they can make money for the investors. That is kind of the American way, isn't that right? Isn't that what everybody, all businesses, would like to do?

Mr. GENSLER. All businesses would like to have the performance that these entities have had. These entities also pursue a public mission that this Congress and prior Congresses laid out, and they have certain Government benefits that help in their performance.

Ms. WATERS. We understand that. We understand the reason for their existence. And one of the things I have come to appreciate about them is the access that we have in trying to work with them to meet the needs of our constituents. I just had a big hearing in my district by ACORN. Are you familiar with ACORN?

Mr. GENSLER. Yes.

Ms. WATERS. And it was about predatory lenders and subprime lenders and what is happening in communities such as part of my district where many of the subprime lenders are taking advantage of my constituents and I am working with Fannie Mae in particular to really strengthen and expand opportunities to support these mortgages. So I don't see any problem. We have access to them. They are managed well. And I just don't want anyone to listen to this hearing or to go away thinking that there is a problem

or there is some kind of risk that exists at this time. Now let me ask, are you familiar with FM Watch?

Mr. GENSLER. Yes.

Ms. WATERS. Do you know who they are?

Mr. GENSLER. Yes.

Ms. WATERS. You know they are worried about competition?

Mr. GENSLER. I am not familiar with all of their worries, but I have read some of their papers.

Ms. WATERS. Well, why do you think they are in existence and what do you think their stated mission is?

Mr. GENSLER. I haven't read their mission.

Ms. WATERS. You have got to know. I mean this is your business. This is one of the most talked about attempts to limit the abilities of the GSEs to expand or to do what they do and that is why this is something I think we should concentrate on today. You know, increasingly I find myself in a position here in Congress in the middle of fights.

On the one hand, we have those who tout the American way and let the marketplace work and tout what competition is all about, but then we have those entities that when they find that they are not doing as well, they come to Government and they ask for more regulations so that they can place themselves at a better advantage. Now I know I sound like a Republican right now talking about these regulations. I can't imagine having to take up the Republican arguments about the marketplace and about getting rid of regulations that attempt to create some advantage for one side or the other, but that is what this seems like to me.

Mr. GENSLER. Well, I think, Madam Congresswoman, if I may, the GSEs have significant benefits in funding advantages, capital advantages, and cost advantages. Treasury looks at all financial institutions to determine how can we help promote the financial system by promoting transparency, private market discipline, and competition. And it is in that context of how we mitigate systemic risk. And there are times when we can benefit the system by mitigating systemic risk through prudent steps that lessen uncertainty and promote the economy.

Ms. WATERS. But it is impossible to mitigate what does not exist and so we are talking about anticipating possibly something that may happen in the future that we have got to design mitigation for. And, you know, it seems to me that when we talk about transparency, just last week in the subcommittee we approved the Hedge Fund Disclosure Act that specifically refrained from requiring hedge funds to submit such information based on the notion that it is proprietary information. We put the hedge funds at a competitive disadvantage.

Nobody wants to give away its formula for success. People don't just give it away. And if those who want to compete with them want to compete with them, they got to come up with a better mousetrap and I don't want to be used to do that. So I guess what I am saying to you is I appreciate the role that you play and the concerns that Treasury must have, but we don't have a problem here.

Chairman BAKER. Would the gentlelady yield?

Ms. WATERS. Yes, I will yield.

Chairman BAKER. Thank you. We have a series of votes and I want to ask for a response, if I may, before we recess, I just want to make sure I understand the gentlelady's concerns. We from time to time disagree on policy.

Ms. WATERS. Yes.

Chairman BAKER. Are you suggesting——

Ms. WATERS. To say the least.

Chairman BAKER. Sometimes we work together. Are you suggesting that my legislative effort is in some way tied to Fannie Watch?

Ms. WATERS. Well, here is what I am suggesting.

Chairman BAKER. If you can just give me a yes or no.

Ms. WATERS. I am suggesting that it may be and you may not know it.

Chairman BAKER. Well, I can fully assure the lady I have worked on this proposal for about a year with representatives of every financial regulator, the GAO, the CBO, and at no time have I vetted this proposal with any representative of Fannie Watch nor am I a dupe of Fannie Watch nor do I appreciate the lady's——

Ms. WATERS. I have not accused you——

Ms. JONES. Will the Chairman yield?

Chairman BAKER. It is not my time. It is the gentlelady's time.

Ms. WATERS. It is on my time. Reclaiming my time.

Chairman BAKER. I would point out her exceeded time, but she may continue.

Ms. JONES. Will the gentlelady yield for a moment?

Ms. WATERS. Yes, I will yield.

Ms. JONES. Mr. Chairman, we are not suggesting that you are connected, but I would wish that you would have one of your staff people turn on the web page of FM Watch and read what it says on the web page about your legislation. You may not think it is connected, but I suggest you read it.

Chairman BAKER. If the gentlelady will continue to yield, I would suggest she read the Treasury testimony of this morning, which is your Administration, which says this proposal is well-founded and reasonable, and I thank you for both your comments.

Ms. JONES. You asked were you being connected with FM-whatever-it-is, and I am just suggesting that you read the website.

Ms. WATERS. Now reclaiming my time.

Chairman BAKER. No, your time is exhausted. We are down to——

Ms. WATERS. Unanimous consent for one additional minute.

Chairman BAKER. The gentlelady is recognized.

Ms. WATERS. Thank you very much. I am suggesting—first of all, let me be clear. I am not suggesting that you are a dupe. I am not suggesting that you are carrying the water for, I am not suggesting that you have met with them and you have worked out a deal, I am not suggesting any of that. But what I am suggesting is FM is out there and it is formed and organized for one reason, it wants to limit the competition so that it can be at better advantage to seek some of the same markets that these GSEs have. That is a fact of life.

And so we don't have any risk. We don't have any unsoundness. We don't have GSEs that are unstable. We only have them that are

performing, performing well, and doing a pretty good job. Now I want to tell you I have my differences with them from time to time and I am pushing them and I want them to expand to be able to provide more mortgages for poor people.

I am not saying that they are everything that I want them to be, but what I am saying to you is that in a time when we should all be worried about spreading out this wealth and making sure that all communities have access to the opportunities so there can be more mortgages, more capital flowing. We should be dealing with that and not doing the business that will enure to the benefit of the FM Watch, because that is all that this does.

Mr. KANJORSKI. Will the gentlelady yield?

Ms. WATERS. Yes, I will yield.

Mr. KANJORSKI. I know that the gentlelady was not here for all the opening statements and comments, and I would just say that I guess if we look around this room and read some of the web pages, we probably could conclude that this is a battle of the Titans. But in reality, I think it is an opportunity to slowly examine these issues and that commitment has been extracted from the Chairman, and that this is not something that is going to move very quickly, and probably not in the form that it has been drafted. This hearing is merely a platform to examine issues.

Ms. WATERS. Well, reclaiming my time, yes.

Mr. KANJORSKI. I am very supportive of the distressed communities in the need for fairness.

Ms. WATERS. Sure.

Mr. KANJORSKI. This may give us an opportunity to use the GSEs to accomplish just that.

Ms. WATERS. Reclaiming my time, if I may, and you have been very generous, Mr. Chairman. I really do appreciate it.

Chairman BAKER. Just remember.

Ms. WATERS. I will. But reclaiming my time, why don't we have a series of hearings, why don't we take them out into the country, why don't we have legislation that is now being produced to anticipate——

Chairman BAKER. If the gentlelady will give me just a moment.

Ms. WATERS. OK. All right.

Chairman BAKER. We are getting close to our vote time here.

Ms. WATERS. OK.

Chairman BAKER. If I had suggested reform and didn't have a specific proposal, criticism would be leveled. It is a generic hodge podge of unformed suggestions that make no sense cobbling together, and how can we give you a response if you don't have a specific idea? What I placed before the Treasury and the other regulators, from whom eventually we will hear some time in this coming week, is a specific proposal for their review and comment.

I even circulated it to the CEOs of Fannie, Freddie and the Home Loan Bank. We have visited with anybody who said, “Baker, what are you up to?” This is not a sneak attack. It will not move fast, but I want to assure the lady I am going to do everything possible to see this proposal move forward in some fashion, because whether you agree with me or not, the ultimate end game of all of this is to continue the GSEs to perform their public mission, which, by

the way, I don't think you think they do all that well, based on what I read in the paper recently.

Ms. WATERS. They are doing better than these predatorial lenders.

Chairman BAKER. I got information that might surprise you. But, second, that they do not engage in activities which present unknown risk to future taxpayers without at least us asking the questions. Am I to understand that we are to let any business enterprise engage in such massive scale of activity and not ask the questions? We may not like the answers. We may not agree at the end of the day. But what is being presented here is merely a mechanism by which competent regulators can inform you and me as to what actions we may need to take in the future.

So, understanding that the gentlelady is not suggesting that I am being manipulated by the free market forces and understanding——

Ms. WATERS. I would not ever suggest that.

Chairman BAKER.——that the lady suggested additional hearings, which we certainly will have. I think Members will be probably quite tired of hearings by the time I get finished. I just want you to understand when this is at the end of the path, your Administration is finding some merit in this proposal, and I intend in some manner to offer it for your consideration.

Ms. WATERS. If I may, and I know that my time has——

Chairman BAKER. Everybody's time has expired. We are really——

Ms. WATERS. Mr. Chairman, Mr. Chairman, you just supported the bill that restructured banking——

Chairman BAKER. I actually wrote that bill.

Ms. WATERS.——that handed the opportunity for banking to get into every business that it wants to.

Chairman BAKER. With regulation.

Ms. WATERS. You took down the walls.

Chairman BAKER. With regulation.

Ms. WATERS. You did all of that, and I remember your arguments were quite different.

Chairman BAKER. No, they weren't. No, they weren't.

Ms. WATERS. In relationship to banking and modernization than they are now when you talk about the original mission. I can tell you what the original mission of banks was.

Chairman BAKER. The gentlelady is raising an issue which we clearly have differences on. My policy on Government regulation for enterprise, GSEs is consistent. We will debate this ad finitum for coming months. We should stand in recess pending the vote and reconvene.

Mr. Under Secretary, I appreciate your continued patience. We will return.

[Recess.]

Chairman BAKER. Mr. Secretary, while we are awaiting the return of Members, I am told we will have about thirty minutes to an hour likely before the subcommittee is interrupted again for votes. I would just like to revisit some of the ground that has been plowed haphazardly this morning.

The principal concern prospectively is concentration in individual institutions, concentration in the broader capital market, and insuring regulatory capacity to assess potential consequences of that concentration. Is that a fair statement?

Mr. GENSLER. I think so, sir. I think also that it is the balance of the benefits, the benefits of promoting the public missions that these institutions do, and as many Members have said, do effectively. And the balance vis-a-vis the risk that you have just identified to the financial system either as articulated by systemic risk or by the risk to market competition. And as time changes and financial market changes, the appropriateness of reconsidering that balance.

Chairman BAKER. And with regard to, I call it loan-to-one-borrower limit, from my perspective, that is the most immediate and concerning issue. Would it be appropriate for us to look beyond studying that case, either make the current loan limits to one individual applicable to the GSEs, do we do that over a period of time or do we simply give the regulator the authority to continue to monitor and make recommendations in the future? How on that scale of progression are you suggesting we should move today?

Mr. GENSLER. The exposure limits or loan to one borrower limits are one of the important protections of the safety and soundness of the banking system. We think that it is appropriate to take a very serious look and actually bring all borrowers, including GSEs, under those same consistent limits to help mitigate risk in the banking system. We think you would want to take that step over sufficient time and transition, make sure to thoroughly consider all points of view, and have all parties comment on it, but we think it is an appropriate goal.

Chairman BAKER. Thank you.

Mr. Hill has returned and he was next for recognition.

Mr. HILL. I presume, Mr. Chairman, it is for the customary thirty minutes as the last exchange was?

Chairman BAKER. Absolutely, as long as you have a slightly different perspective on the circumstances.

Mr. HILL. Thank you, Mr. Chairman.

Mr. Gensler, I am trying to—I guess I would say that this bill contains lots of good ideas, probably some not-so-good ideas, and I think the Treasury's testimony seems to suggest that it supports some of them, perhaps not all of them. I am trying to get a sense of what the problem is here and then focusing on what the solution ought to be and what the goal ought to be as a consequence of that.

And it seems in your testimony what you said was that in essence, because of the size of the GSEs now and their dominance to the market or the extent of their market share that there is greater systemic risk and there is greater risk to them as a consequence of that.

Mr. GENSLER. I think, Congressman, that is right. I would add that our capital markets are so efficient that with good management small advantages can be used to dominate markets and to grow rapidly. And so the advantages that Congress has bestowed upon the GSEs in pursuing their mission has both promoted that mission, but at the same time, those advantages would suggest that the GSEs growth would continue and that their growth would

be faster than the economy and faster than the markets themselves.

Mr. HILL. Those are two separate issues as I would see it. One is are these risks so large that they are not manageable or are we not adequately managing them or are we not regulating them sufficiently that they are adequately managed. That would be question one. And then the other question is are these advantages such that it either stifles competition or limits competition that will cause a greater concentration of market share in the GSEs.

I presume from what you just said that you believe that those advantages will further give them further advantage and increase market share.

Mr. GENSLER. I think that has been the history of capital markets, particularly with good management, that those advantages will lead to increased market share.

Mr. HILL. Are there some costs associated with this mission too? Are there some disadvantages that go with the mission that Congress has given to these GSEs?

Mr. GENSLER. I think it is. I have chosen to use the word on behalf of the Administration of balance, because there are benefits provided to the GSEs, and there are benefits in our housing finance market and great innovations that have come forth from these GSEs over many decades. But at the same time the balance of what the scale of these institutions will be and what it does to market competition should be considered.

Mr. HILL. But the goal here is to maintain some balance. Perhaps you are suggesting it is imbalanced now. Are you suggesting it has to be rebalanced, is that what you are saying?

Mr. GENSLER. I think that thoughtful consideration is appropriate from time to time. As I understand it, the last time that Congress took this up was in 1992 and since that time the GSEs have close to quadrupled in size. They now are about 63 percent of the conventional conforming mortgage market. And so it is appropriate to look at it as I am sure you will be wrestling with for years to come.

Mr. HILL. Going back to the chart that everybody has made reference to, we are not arguing here that we want to have fewer mortgages. You are arguing here just simply that the amount of GSE debt is going to grow faster in proportion to the overall economy.

Mr. GENSLER. Let me speak as a technical matter, if I might for a minute, because I had a chance at one of the breaks to read the footnotes on the Chairman's chart. The debt represents here is the debt of the three GSEs. In addition to this and somewhat separate from this they guarantee mortgage-backed securities in the marketplace of about $1.2 trillion.

This debt is growing. As they purchase mortgages and hold them within their portfolio, and as the dialogue continues, I think this chart should not suggest something about their guarantee business. This is more, this chart here, about their portfolio business.

Mr. HILL. Mr. Chairman, if you can indulge me one last question. Going to this line of credit question, and I think that it is an admirable goal to make clear to investors that the securities backed by the GSEs are not guaranteed by taxpayers, but this line of credit

isn't the typical kind of line of credit. I mean the GSEs can't just draw upon this line of credit any time they want to on the basis of what they think their need is. Is that a correct understanding?

Mr. GENSLER. That is correct, sir. It is actually written into statute that the Treasury Secretary has authority to purchase securities.

Mr. HILL. The question I have with respect to that if we were to repeal that is simply this: are there circumstances under which you think that it may be an advantage for Treasury to be able to add liquidity to the system through the GSEs that would be prohibited if we repealed that provision?

Mr. GENSLER. The line of credit, at least for Fannie Mae, was put in place actually when Fannie Mae was part of the Government and kept in place as they were put out into the private sector. But it is really at this stage such a small number. As we said, these institutions have grown so significantly since their lines of credit were put in place that it has, at this stage, not a true ability for Treasury to use.

I would also note Treasury does not have such ability with any other financial institution, so our consistent approach is to look at financial institutions similarly to promote private market discipline and promote private markets to be a moderator on risk-taking as best they can.

Mr. HILL. So eliminating this provision isn't going to weaken the system in any way in your view or weaken Treasury's ability to respond to a crisis that might occur? It has not ever been used, is that correct?

Mr. GENSLER. It has not ever been used in a crisis. There was one time as I understand it in the 1970's that it was used with regard to Freddie Mac in a small proportion, I think at that time actually to promote a mission goal, but I haven't researched that well enough.

Mr. HILL. Thank you very much.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Hill.

Mrs. Maloney.

Mrs. MALONEY. Thank you, Mr. Chairman, and welcome, Mr. Gensler, and thank you again for all your diligent work with all of us on the financial modernization bill. And, Mr. Baker, I look forward to working with you on this bill although I do have some questions. The GSEs actually have played a very important role in the city that I represent, New York, and as my colleagues are aware, home ownership in the United States is extremely strong, and the GSEs have played a role in that.

We are now at over 70 million families owning their own homes, yet at the same time we have room for a great deal of improvement. Home ownership rates for minority groups trail those of whites by more than 20 percent and as the mission regulator of Fannie and Freddie, Secretary Cuomo's recent decision to increase their affordable housing goals I believe is a tremendous step forward in addressing this serious problem and disparity.

The Secretary's decision and action demonstrates one of the achievements of the 1992 GSE Act by splitting regulatory oversight of the GSE's public mission and oversight of safety and soundness

between two regulators. The Act seeks a balance between the two objectives. I support the Chairman's objective of simplifying and strengthening regulation, but I think we have to be aware of unintended consequences of a sweeping rewrite of GSE, particularly in light of OFHEO's finally completing their risk-based capital standard.

And just last year, as part of modernization, we passed significant reforms to the Federal Home Loan Bank System for which substantial credit is due to the Chairman and the Ranking Member. And I agree with Mr. Bentsen that it might be more appropriate to see how the new risk-based capital rule and the post financial modernization of the Federal Home Loan Bank System operates before we redraft their total regulatory structure. But I have some specific questions on the bill. Do you believe there would be any impact on mortgage rates from H.R. 3703?

Mr. GENSLER. Congresswoman, I just want to start and thank you also, because the experiences that we had with this entire committee, and I know that we talked a lot on financial services legislation, was productive and it is good to be back together.

Mrs. MALONEY. You were terrific at 9:00 in the morning and at 4:00 in the morning, all those meetings, but it is good to see you again.

Mr. GENSLER. Good to see you. Thank you. I think that you are correct to say that housing finance has been benefited in this country by the GSEs pursuing their mission. The issues that we are discussing here today—how to lower risk, and how to lower uncertainty—are always part of the sound promotion of our financial system. I think that that is what is important. To the extent that we can lessen risk and lower uncertainty in the markets, that tends to lower interest rates.

Specific provisions in the bill that are consistent with Treasury philosophy of lowering risk should be better for the markets as a whole. I could not predict what it would do for particular markets or particular segments, but I think overall that it is good for the system.

Mrs. MALONEY. So you think it may lower mortgage rates?

Mr. GENSLER. I don't know, and as a Treasury official we are schooled not to predict what will happen in specific markets, but in terms of the soundness of the financial system our overall approach has been promoting transparency, market competition, and private sector discipline. History tells us as we promote those, we tend to lessen uncertainty for the overall system whether it be one sector or another.

Mrs. MALONEY. The bill would require GSEs to gain approval from the newly created regulatory board for any new program. It is beyond argument that the new regulator would therefore be more intimately involved in approving programs than is the case in the current system where there actually is no approval system. Is there a danger that the Government's increasing involvement in GSE's daily business that the markets could perceive a Government guarantee to be explicit, which would increase a systemic risk?

Mr. GENSLER. I think that it is important that the GSEs be able to pursue their mission in an innovative and competitive way, but

at the same time they should stay focused on that mission as Congress clarifies what that mission is to be. There are benefits in funding and leverage and other benefits that the GSEs have and so I think that Congress has been careful to only provide those benefits to accomplish a focused mission.

We do think that we would want to make sure that people can be innovative and focus on the mission, but at the same time not to be able to use those benefits beyond the mission. And I think that that is an appropriate role for the mission regulator, to be helpful that people are focused on mission, not beyond the mission.

Mrs. MALONEY. But have they had examples in the past of programs that are beyond the mission? I am not aware of any.

Mr. GENSLER. The challenge, it is a good, but hard challenge, is as a private sector firm maximizing one's opportunities. If one has advantages by the Government, these various advantages of being able to borrow at cheaper rates with higher leverage ratios, that the motivation will always be to maximize the opportunities and that is what we want the private sector to do. But as Congress has bestowed certain advantages, even small advantages can be used in many other markets and so I think Congress has spoken that you would want it to be focused on the mission, not in other markets beyond the mission.

Chairman BAKER. Can you wrap up, Mrs. Maloney?

Mrs. MALONEY. Pardon me?

Chairman BAKER. Can you wrap up?

Mrs. MALONEY. OK. My time is up.

Mr. GENSLER. Oh, I am sorry.

Chairman BAKER. Ms. Hooley.

Ms. HOOLEY. Yes, thank you. Mr. Secretary, I apologize. I have been in and out today, but part of my problem as I am sitting here listening to this is I guess I need to understand the problem. You know, what are we trying to do? Are we trying to reduce the risk? Are we trying to—there was a chart up earlier, are we trying—or maybe the same chart is up. I just don't have my glasses on. Are we trying to reduce the debt? Are we trying to rein in GSEs? What are we trying to do? What is your perception of what we are trying to do in this particular piece of legislation?

Mr. GENSLER. I think to lessen the risk of the financial system, recognizing that the GSEs have bestowed upon them from Congress certain benefits, and that those benefits in the very competitive capital markets we live in can be and generally will lead to increased market share and increased dominance. Now the history of the GSEs is they performed well. Housing finance in this country is very strong.

At the same time there is a balance of bestowing these Government benefits and recognition that growth and scale itself can raise issues of risk to the financial system and risk to market competition. We have looked at it through the lens of mitigating risk, mitigating systemic risk, and that is through the same way we look at it for other financial institutions.

Ms. HOOLEY. Do you think the current arrangement actually adds to the riskiness of the GSEs?

Mr. GENSLER. I think by bestowing Government benefits on any financial institutions you add to their ability to grow and dominate

markets, that in and of itself, when one or two firms come to dominate a particular sector of the financial markets the pricing mechanism is at risk, the pricing mechanism within that capital market. Also other financial institutions who do not have those advantages can tend to take on risk themselves.

Taking on risk is sort of left to less profitable businesses as they do not have the advantages that the Government bestows. Still though, as I say, if we focus and as you focus on the mission, we want people to be innovative in that mission and manage their risks within that mission.

Ms. HOOLEY. Just a quick follow up. There are agencies where they have come under one regulator, but have two totally different missions that have gotten into trouble, because it is hard sometimes to serve both of those missions under one regulator. Do you see that as a problem occurring under the proposal in this legislation?

Mr. GENSLER. I think that the challenge that you highlight is one that we do address in the testimony a bit. We think it would be, if there are efficiencies to bringing the regulators together, beneficial that Congress clearly lay out the GSEs' specific missions as it was earlier said the Home Loan Banks pursue their housing mission differently today than Freddie Mac or Fannie Mae. We must also make sure that the GSEs stay focused on their intended mission, particularly because Congress has provided Government advantages to achieve that mission.

Ms. HOOLEY. So you think under the new regulation it is going to bring down the debt?

Mr. GENSLER. I am sorry?

Ms. HOOLEY. Under the new regulator, do you see that bringing down—I mean if you look at those lines, do you see that bringing down the debt?

Mr. GENSLER. We really focused on recognizing there is this growth and how can we help mitigate risk. I don't know whether this line will be higher or lower than that line, but regardless of where these lines are, I think our duty at Treasury is to highlight those ways to mitigate risk such that regardless of whether this line is a little higher or a little lower there is less risk in the system.

Ms. HOOLEY. Can there be less risk under the current system?

Mr. GENSLER. I think that again reconsideration is appropriate. It should be thoughtful and balanced, and all parties should be involved, but reconsideration is appropriate from time to time as financial conditions change. Since the early 1990's, the size of the GSEs has quadrupled. It is likely to double in the next five years and so just that in and of itself makes it appropriate to take these matters up in times when the economy and housing finance is strong. This is the time that I think we would all rather be discussing this than if the opposite was true.

Ms. HOOLEY. Thank you.

Chairman BAKER. Thank you, Ms. Hooley.

Mr. Kanjorksi wants a minute.

Mr. KANJORSKI. Mr. Secretary, because we are expanding some of those missions to take into consideration economic development, community development, infrastructure development in distressed

communities, it is only reasonable to assume that we can look forward to the cooperation of Treasury in revisiting the issue of economic development and the use of GSEs toward that end?

Mr. GENSLER. We look forward to working with you and the whole committee on discussion of these important matters of public policy. I know that Assistant Secretary Apgar also from HUD is going to talk about the mission and the regulation in that regard as well.

Mr. KANJORSKI. Thank you very much, Mr. Chairman.

Chairman BAKER. Ms. Waters.

Ms. WATERS. Unanimous consent to submit my statement for the record.

Chairman BAKER. I wouldn't object to a thing.

Ms. WATERS. Thank you.

Chairman BAKER. You are quite welcome. Without objection all Members' statements will be made part of the record.

Mr. Secretary, I thank you for your long-suffering patience. We are going to recess. I notify the panel members of the second panel we will reconvene as soon as we return from this vote.

[Recess.]

Chairman BAKER. The hearing reconvenes, and we welcome our second panel of witnesses to the subcommittee hearing this morning. I am told, although I don't know how reliable the information is at this point, we have an hour before we can expect to vote, and I would hope if we continue on we might be able to conclude the hearing within that hour period.

Our second panel is composed of William Apgar, Assistant Secretary for Housing, Department of Housing and Urban Development; Armando Falcon, Director, Office of Federal Housing Enterprise Oversight; and Bruce Morrison, Chairman of the Federal Housing Finance Board. I welcome all three of you gentlemen here this afternoon and look forward to your remarks.

Secretary Agar, would you care to proceed?

STATEMENT OF HON. WILLIAM APGAR, ASSISTANT SECRETARY FOR HOUSING, FEDERAL HOUSING COMMISSIONER, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Mr. APGAR. Thank you, Mr. Chairman, Representative Kanjorski when he returns, other Members of the subcommittee. I am pleased to be here today on behalf of Secretary Andrew Cuomo to testify on the effect of regulation of the Government Sponsored Enterprises or GSEs. The Secretary has delegated to me much of the responsibility for insuring that Fannie Mae and Freddie Mac, the two GSEs, are fulfilling their public mission responsibilities.

As we have heard, these two enterprises enjoy considerable advantage over their private sector competitors and HUD is committed to achieving their public responsibilities. The intent of my testimony today is that HUD is doing its job and has proven to be an effective regulator of the GSEs, yet we believe regulatory oversight of the GSEs can be enhanced and to the extent the provisions in H.R. 3703 strength and regulatory oversight they merit careful attention.

Before providing some specific comments on the bill, let me review our current regulatory initiatives. First, of course, I would like to comment on our regulation relative to the affordable housing goal. As you understand, last year Secretary Cuomo announced plans to substantially increase the Congressionally mandated affordable housing goals that will require Fannie Mae and Freddie Mac to purchase as many as $2.4 trillion in mortgages over the next ten years providing affordable housing opportunities to 28.1 million low- and moderate-income families.

So this is an aggressive expansion of the affordable housing goals and we think that merits serious attention by all Members. Substantially higher goals will require that beginning next year a large share of the activity of Fannie Mae and Freddie Mac will benefit families of low- and moderate-income. The new goals will substantially increase access to housing capital in many of our Nation's underserved communities and underserved groups.

Additionally, the department has been active recently in mounting the most extensive fair lending review of the automated underwriting systems of the two GSEs. HUD initiated this first review in the fall and it is now well underway. In light of the importance of the GSEs' underwriting standards and growth of their automated systems in determining whether families realize the dream of home ownership this review is timely and essential.

After much discussion and recognizing the need for protecting important proprietary information, Fannie Mae has provided requested information and negotiations are still underway with Freddie Mac. We think this information that we are receiving will allow us to effectively evaluate these important automated underwriting systems. Unlike other areas of HUD regulations, where I have chief responsibilities, the automated underwriting review is the responsibility of the Assistant Secretary for Fair Housing and Equal Opportunity and she shares that duty with our general counsel.

We have other areas of regulatory oversight that I would like to highlight. We are also active in the review of new program activities. Recently HUD requested information on a number of GSE initiatives including their mortgage insurance initiatives and their various Internet activities to see if they are operating within the context of the charter, in the public interest and with an eye to safety and soundness.

Finally, we are active in reviewing their non-mortgage investments. We know this has been a particular concern of Chairman Leach. HUD issued an Advance Notice of Proposed Rulemaking on this topic and we have a major study underway to guide us in how to effectively monitor the GSEs' activities and non-mortgage investment arena. And last, but not least, we are busy trying to insure that there is availability of public information on GSE activities. We maintain an extensive public use database containing information about GSE activity and we begun to release additional tabulations of GSE activity to better inform the public of the activities of these two entities.

With respect to the specific legislation, it is our general feeling that the existing structure works well and we believe that is backed up by our record of achievement in oversight activities in

recent years. But at the same time, we believe that it can be improved upon and we welcome the opportunity to work with the subcommittee on enhancing overall GSE oversight. In creating the structure, Congress recognized the importance of establishing Cabinet level emphasis on GSE oversight and insure that there was consistency with respect to GSE oversight and its link to overall housing policy.

At the same time, the recognition of the separate and important role of safety and soundness regulations through OFHEO, we think, was well taken. H.R. 3703 includes a number of helpful comments to enhance GSE regulations that we believe are worthy of careful consideration. These include the authority to assess GSEs; the full cost of the regulation, including mission regulation; clarifying and strengthening HUD's existing authority to review new program activities; and further Congressional directions for limitations on GSE non-mortgage investment.

In my written statement, I outline these in more detail. We think in each area those elements of the bill that can enhance overall GSE oversight are well taken. In addition, my written testimony addresses some issues relating to fair lending enforcement. H.R. 3703 would have HUD retain its general authority in this area over the GSEs. However, as we read the bill, the enforcement activity for this authority, which currently resides with OFHEO, would be transferred to the new entity and we are concerned that this would fragment our regulatory oversight in this important area of fair lending and think we need to continue to work to clarify that aspect of the oversight of the GSEs.

In conclusion, we believe that HUD is providing strong and effective mission regulations of the GSEs. The current structure is working well and it is having a valuable impact on affordable housing markets. At the same time we readily acknowledge that, given the changing market conditions over time, there may be a need for revision to the existing GSE regulatory oversight structure as was suggested by Secretary Gensler.

So, in the meantime, Secretary Cuomo and I look forward to working with the subcommittee as we build on the strengths of the current system and make the needed adjustments to make it work better in the future.

[The prepared statement of Hon. William Apgar can be found on page 162 in the appendix.]

Chairman BAKER. Thank you, Mr. Secretary. We appreciate your testimony.

Our next witness is Director Falcon, who I understand returns for the first time since your appointment to your old banking haunts, so welcome back.

STATEMENT OF HON. ARMANDO FALCON, JR., DIRECTOR, OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

Mr. FALCON. Thank you, Mr. Chairman. It is indeed a pleasure to be back here in the room of the House Banking Committee. I do have nothing but fond memories of my time here serving on this committee. I must say I appreciate the opportunity to appear before you today to discuss H.R. 3703, the Housing Finance Regulatory Improvement Act. Mr. Chairman, I first want to commend

you for your ongoing commitment to ensuring the best possible oversight of the GSEs and reiterate my support toward achieving these things.

You and Representative Kanjorski have brought real leadership to GSE issues in general, and I look forward to working with you and your colleagues on the full committee to ensure the best possible oversight structure for the enterprises. As you know, since OFHEO began operating in 1993, Fannie Mae and Freddie Mac have doubled in size to over $2 trillion in assets and mortgage-backed securities guaranteed. The need for strong oversight is more critical now than ever before.

As Congress considers the changes you have proposed, I want to assure you that there is a very strong regulatory system already in place. OFHEO works well as a safety and soundness regulator for Fannie Mae and Freddie Mac. The only major shortcoming, which I will address later in my testimony, is OFHEO's lack of financial independence.

OFHEO's top-notch examination program consists of an annual comprehensive risk-based assessment of the health and management of the enterprises.

Also, as I am sure you are aware, we are moving expeditiously to implement a final risk-based capital rule. Mr. Chairman, I take your comments in your opening statement to heart. The risk-based capital rule is unacceptable and I make no excuses on behalf of OFHEO. I only want to assure you that my focus here is to get the job done and that is my number one priority at OFHEO to finalize the risk-based capital rule.

OFHEO also conducts sound and authoritative research and analysis which enables us to become even more proactive in our oversight of the enterprises. While the current system is working well, that doesn't mean it can't be improved. Consolidation of the safety and soundness regulation of the housing GSEs could lead to even stronger oversight, if done properly. However, the consolidation of mission regulation with safety and soundness regulation is not essential for OFHEO or its successor to properly fulfill its safety and soundness responsibility.

The lack of mission oversight does not hinder OFHEO's effectiveness or ability to do its job. Any need OFHEO may have to be informed about developments in mission regulation can be satisfied through the open lines of communication that exist between OFHEO and HUD. Nor has mission regulation suffered. Secretary Cuomo and Assistant Secretary Apgar have demonstrated their strong commitment to fulfilling HUD's mission oversight responsibility.

I have several comments to make on H.R. 3703. The structure and authorities of the regulator created under the bill would maintain and, in some ways, even improve oversight of Fannie Mae and Freddie Mac. As provided for in your bill, more disclosure and transparency of the enterprises' activities would serve to increase the efficiency of the secondary mortgage market.

OFHEO already contributes toward this goal by disclosing the results and conclusions of our comprehensive annual risk-based examinations. In addition, the bill would require the regulator to obtain annual credit ratings for the enterprises from rating organiza-

tions. OFHEO obtained such a rating in 1996. With adequate funding, regular updates of this type could provide more information to investors about the enterprises' financial condition.

The bill also reflects prudent public policy by providing for an appointment of a receiver for a GSE when necessary. The absence of such provisions serve to weaken market discipline by reinforcing the market's perception that the enterprise securities are implicitly guaranteed by the Government.

I would like to address the regulatory structure contained in the bill. I believe that a single agency head is preferable to a board. This structure has proven effective and efficient for OFHEO.

First, the single agency head focuses accountability on one individual rather than on diffusing accountability among numerous board members. Second, a single agency head unifies day-to-day management of the agency in one person, which avoids the confusion, dissension, and gridlock, which might sometimes be associated with boards. Also, a single agency head allows the agency to move quickly in reacting to the risks of the companies that it regulates.

Whatever Congress decides on the final structure of the new agency, I know you will agree that the bill should do everything possible to ensure the success of the new agency. To that end, I strongly believe that the bill's transition period needs amending. First, the nine-month period, I believe, is far too short. I would recommend that the bill include a longer, more practical transition period.

During this period, the duties and functions of the existing agencies could be combined, allowing the integration of the agencies before the management assumes responsibility. This is especially critical if the new agency is set up under a board structure, because it would allow the new board to inherit a fully integrated agency. Finally, this longer transition would accommodate a more orderly merging of the technological and regulatory infrastructures of the agencies.

Mr. Chairman, I would like to end with one final point, which I believe is critical to the success of OFHEO. I share your view that safety and soundness regulators need to be free of the uncertainty and inflexibility of the annual appropriations process. This is why I wholeheartedly support the bill's funding mechanism. I feel very strongly that the current situation of subjecting OFHEO to the appropriations process is simply bad public policy.

That is why I ask this committee to remove OFHEO from the appropriations process. This would put us on par with all other safety and soundness regulators. I want to be clear that this change would in no way remove OFHEO from appropriate Congressional oversight. OFHEO would continue to be subject to the oversight of this committee and would still have to meet all annual statutory reporting requirements. Removing OFHEO would simply provide me with the flexibility I need to respond quickly to changing conditions, especially a deteriorating one, of the enterprises or the market.

I want to thank you for your support of our previous budget requests as well. I want to also thank you for taking the lead on this appropriations issue. I hope that with our combined efforts we will

achieve this goal this session. I would like to end by thanking the subcommittee again for the opportunity to testify this morning. As I stated, OFHEO is adequate to the test, but that does not mean that improvements cannot be made. I am committed to working with the Congress and this committee to ensure that the system for regulating the Government Sponsored Enterprises is as strong as possible.

[The prepared statement of Hon. Armondo Falcon Jr. can be found on page 171 in the appendix.]

Chairman BAKER. Thank you very much. We appreciate your presence here today.

Returning again after many visits and as a former Member, welcome, Bruce Morrison.

STATEMENT OF HON. BRUCE MORRISON, CHAIRMAN, FEDERAL HOUSING FINANCE BOARD

Mr. MORRISON. Thank you very much, Mr. Chairman, and to you, Mr. Kanjorski, as well and to other Members of the subcommittee. It is my pleasure to be here and I look forward to sharing some viewpoints on H.R. 3703 and related topics, but let me start by asking that my written testimony be included in the record and that that testimony also include my prior testimony in 1997, which addressed this subject as part of the subcommittee's earlier consideration of regulatory structure.

Chairman BAKER. All testimony of all witnesses will be made part of the official record without objection.

Mr. MORRISON. I also want to thank you, Mr. Chairman, and Mr. Kanjorski, in particular, for your leadership that led to the enactment of the Modernization Act for the Federal Home Loan Bank System last fall. As you know, this was a project with a long time in preparation and the success which was achieved last fall is due to both of you and your cooperation and your diligence in pursuing it, and it is very much appreciated.

I want to report to you that the Finance Board has taken very seriously the job of implementing that legislation. We have in process all of the regulatory changes that are required. Many of them have already become final. By April 12, we will have proposed regulations or issued final regulations for all aspects of statutory change in that legislation except for the capital provisions. The capital provisions will be proposed in regulatory form toward the end of May and we expect to meet the statutory deadline in November for final regulations.

As I committed in a letter to the Congress—to the Chairman of the House and Senate conferees—at the time we had been consulting with Members and Member staff in that process, we welcome any input from Members of this subcommittee as we go through this regulatory process. In particular, I want to point out that we are about to propose regulations modifying the collateral that can be accepted by the Federal Home Loan Banks.

This is important for two particular reasons. One, it will allow small institutions a much broader access to the advances of the Federal Home Loan Bank System and it will allow all banks greater access to advances to support economic development lending, because real estate collateral much more broadly than previously will

be available to support advances. So in both of those ways the goal of the Congress in expanding the reach of the Federal Home Loan Bank System to Main Street credit needs will be benefited, and we are moving as expeditiously as possible consistent with safety and soundness to implement those changes.

Now with respect to H.R. 3703, I think the most important thing to be said is that I very much support the goal that I know you, Mr. Chairman, have and I think that is shared by your colleagues regardless of what their views are on the details. That goal is that the regulation of GSEs needs to be efficient and effective. It should not be so intrusive as to interfere with their accomplishing their mission. It should make sure that they are safe and sound and it should also make sure that they are accomplishing the mission that Congress intends on behalf of the American people.

There can be focuses on individuals in particular roles and individual administrations in talking about this issue. I think we should separate ourselves from those kinds of discussions. Any individual can make the best of a particular structure, but the structure should be refined to maximize the ability of whomever may come and go through these positions to see to it that effective GSE regulation results.

In my experience in five years as Chairman of the Finance Board, I must say that the challenges of mission regulation are great. This is not a popular subject with the regulated entities. The regulated entities think of themselves as private corporations and they find regulation of their mission to be intrusive no matter how efficiently it is done. It is also the case that safety and soundness needs to come first, and that mission regulation has always to be consistent with safe and sound operation.

For that reason, I am a supporter of the kind of regime that we have at the Finance Board where safety and soundness and mission are conducted by the same agency. That is not to say that HUD is not pursuing mission aggressively in its current structure nor that OFHEO is not sensitive to mission when it regulates safety and soundness of Fannie Mae and Freddie Mac. It is just that either there are conflicts and they need to be resolved and they are harder to resolve in separate agencies or there aren't conflicts and therefore there is no reason to have them separated.

Mission itself is the touchstone of what makes a GSE different from ordinary private corporations. They don't have different incentives from other corporations in terms of seeking profit. They do have different responsibilities in exchange for their public benefits. It will never be easy for a Government regulator to urge that these kinds of institutions do more than they are doing to accomplish the public purposes for which Congress organized them, nor will it ever be easy to draw lines around what they can and can't do. And yet, those are the distinguishing features of the existence of a GSE.

The stronger the regulator, the more respected by the Congress and by the regulated entities, the better we will do at that hard job. I must say that I think this is a relatively underdeveloped area of regulatory expertise and all of the agencies involved could be improved in that regard. So anything that can be done structurally, or in terms of attracting the very best people, or in terms of improving the tools, or in terms of clarity from the Congress, will all

contribute to what I think we all share as the goal. When Government gives enterprises benefits, they want to see the benefits pass through to the American people and not see them stop along the way for shareholders.

The fundamental difference between a GSE benefit and corporate welfare is that the benefit ends up with the ultimate consumer and doesn't stop along the way. That is our challenge. It is a structural one and it is a regulatory one. I think that this legislation is intended to work on that problem and I commend you, Mr. Chairman, for taking that on, as difficult as it is.

Let me conclude by saying one other thing about GSEs and what the Congress is faced with. There has been a lot of discussion about the graphs. Some folks in this town want to do away with GSEs. They think that they are a distortion of the marketplace. I think they are a choice by the Congress to focus resources in areas that are important to the American people, and I don't think we ought to be pursuing a strategy to try to get rid of GSEs.

I think what we ought to be pursuing is a strategy that sees to it that the American people get the benefits that come from the lower costs. Some of the things in your legislation and some of the additional things that have been talked about this morning have the risk of raising costs without really conferring any additional benefit. I refer for one particular to the repeal of the superlien enjoyed by the Federal Home Loan Banks.

The superlien is an efficient way in which the Federal Home Loan Banks gain a superior claim to collateral. If they didn't have that, they could still gain that superior claim by recording or physically holding each and every piece of collateral that they took as security. That would cost everybody a lot more money. It wouldn't change the fact that the Federal Home Loan Banks' claims were superior to FDIC's. So by doing that you would not advance the goal of changing the priorities in going after assets in a failure, but what you would do is raise the cost of advances and raise the cost of borrowing by member institutions.

I don't think that is the right way to get at that kind of concern. There may be other ways to get at it, but I would avoid that. There are some who are proposing a step-by-step approach to raise the cost of GSE operations in the hope of leveling the playing field between GSEs and non-GSE private firms. If the goal is to reduce the risk to the taxpayer, I don't think it will accomplish the purpose. The risk to the taxpayer comes from the size and importance of these enterprises and that will not go away, because you take away some of the marketplace advantages.

The loss of marketplace advantages will mean higher cost for consumers. That is not your goal, and I don't think that ought to be the goal. If you are concerned about too-big-to-fail, you should worry about how to scale down the size of the assets of the enterprises which can be done consistently with passing through the cost benefits to the consumer. If that is the concern, then that ought to be where the work is done.

The last thing we should do is raise the cost for the consumer and still have the taxpayer on the hook, because that is a lose-lose proposition. And some of the proposals that are being made would lead in that direction. Thank you, Mr. Chairman.

[The prepared statement of Hon. Bruce Morrison can be found on page 177 in the appendix.]

Chairman BAKER. I thank all of you for your testimony. I would like to start with a question I asked Under Secretary Gensler.

If we take regulatory structure off the table so that that is an unresolved issue; if we add to that list, for purposes of this panel, the question surrounding superlien status for Home Loan Banks, can each of you identify any other concerns as in your regulatory capacity that are contained in H.R. 3703 as either ill-advised; you feel should not be supported by the committee; or do you find the balance of the proposals basically safety and soundness recommendations to be an acceptable or constructive approach?

Mr. Apgar.

Mr. APGAR. With respect to the new program review, H.R. 3703 would require the regulator to make affirmative finding of the GSEs before they undertake new activity. We think that is good. HUD currently has the authority to review programs. What we are concerned about though is that the H.R. 3703 limits this review to mortgage-related programs and does not address the GSEs' pursuit of other activities that may or may not fall within their charter, so we think there needs to be some clarity.

We do appreciate the fact that this expansion and clarification of the new program review authority, but we are worried about its limited nature specified in the bill.

Chairman BAKER. On that point, has HUD ever declined a new product request of a GSE?

Mr. APGAR. We have done four reviews. In one instance our efforts were overtaken by Congress that explicitly acted overtaking our regulatory authority. We are currently doing a series of explorations about new activities. We have asked the GSEs to provide it and they have responded with information about their involvement in mortgage insurance-related activities, their involvement in Internet lending activities.

In the case of Fannie Mae, we are asking them to provide us information about an initiative they have with Home Depot, a pilot program for home improvement loans, and with respect to Freddie Mac, we are asking about a new homestead buying center, which is a real estate brokerage effort, all of which we think at least on the surface posed the question of whether they are within the charter boundaries, whether they represent an effective public policy or whether they raise safety or soundness concerns, which is the three criteria we use for doing a new program review.

Chairman BAKER. For example, on the Home Depot pilot, as I understand it, it is limited in scope today, but the constructive elements of it, I believe, is that Chevy Chase Bank would agree to finance home improvement items at the Home Depot store. If a fellow wants to add on a sunroom or put in a jacuzzi, Chevy Chase would extend the credit at the point of sale, and then the paper would be purchased by Fannie at the end of the line, is that correct?

Mr. APGAR. Yes, that is a rough description of the pilot. In our mind, it raises safety and soundness issues and raises other issues of whether it is consistent with the charter.

Chairman BAKER. In some cases I understand that the extension of credit would not necessarily be secured by a home mortgage, it would just simply be a consumer extension.

Mr. APGAR. Yeah, it is on that boundary of consumer lending which we are concerned about. Clearly, this is risky business. This type of lending can experience losses.

Chairman BAKER. I just wanted to bring it to the subcommittee Members' attention as to the types of business expansion that are being considered. For example, two years ago there was a life insurance product that was suggested by Fannie Mae which——

Mr. APGAR. Which was withdrawn.

Chairman BAKER. Yes, but my point is that some have suggested that having any approval process would require disclosure of proprietary business activity that would be to the consumer's disinterest. Chairman Morrison, is it correct that Federal Home Loan Bank has a new product approval process and how does that work?

Mr. MORRISON. Yes, we have had one for what we call pilot programs and that has worked in terms of both a submission process for legal authority and also a safety and soundness review before actual operations. We are expanding the scope of that as part of our collateral expansion process. So I certainly believe that a new activity approval process can work. It requires clarity of mission so you know whether it is inside or outside of the line. And it requires efficiency.

And I don't know whether the publication in the *Federal Register* is a good idea or not. That is in the bill. But such a process must require that things can move rapidly enough so that it is not a bar to innovation.

Chairman BAKER. And to return to my original question, is there any other item in the legislation which you want to bring to our attention this morning that is problematic?

Mr. MORRISON. I would identify the repeal of the Treasury line of credit in this way. As Mr. Gensler explained, this really just vests discretion in the Secretary of the Treasury to buy these securities. Therefore, it is not a compulsion to do so, and as he said, it is largely symbolic since the size of the credit line is wholly insufficient to deal with any real problem in any of the enterprises at this point.

That being the case, this is about sending signals. So if the signal is that there is less connection between the Federal Government and the GSEs, then I would assume the markets would raise the price. I put that in the same category as the superlien. Before you raise the price, you ought to figure out where you are going and whether you are going to change the reality—which I say today is that the Federal Government could not stand idly by while one of these enterprises went bust. Anybody who believes that, you know, believes in the tooth fairy.

That being the case, the last thing you want to do is be sitting with that potential risk and raising the price to consumers along the way. Then you are not getting the benefit of what the implied guarantee actually is delivering right now to the American people, which is a half to three-quarters of a percentage point lower mortgage rates than they would have otherwise.

Chairman BAKER. Thank you.

Mr. Falcon.

Mr. FALCON. Mr. Chairman, I view these issues through the lens of a safety and soundness regulator, so I would defer to my colleagues on commission issues. But there are some positive things in the bill, which deal with greater disclosure and transparency in the activities of the enterprises. I think those can only enhance the safety and soundness of the enterprises. There is an additional provision, which would remove the enterprises' line of credit with Treasury. They each have a $2.25 billion line of credit with the Treasury.

Given that they are combined assets and not balance sheet assets over $2.1 trillion, that is largely a symbolic line of credit and so I don't think it would have a major safety and soundness impact. I think it is largely a question for the subcommittee to determine whether or not that symbolic role of that line of credit should stay or go.

Chairman BAKER. Thank you. I do have a different view on the importance of that symbolic gesture and the pricing of that risk in the market explicitly for that reason to ensure that there is some measure of protection understood by those investors. But one other question——

Mr. APGAR. Mr. Chairman, if I might.

Chairman BAKER. Yes.

Mr. APGAR. I just wanted to make sure I was clear on our concerns about the fair lending provisions. The GSE oversight that we have gives certain authorities relative to fair lending. The way I understand the bill those authorities will remain with HUD, but the enforcement action would go to the new entity. We feel that that would divide our fair housing oversight function both on the GSEs and as it relates to other market players, then we need some clarification on how the fair housing piece of this would work.

Chairman BAKER. That was understood, but I appreciate you for clarifying. We do have other Members and I don't want to go on at length. I have one just final thing that I would like to ask Mr. Falcon. With regard to the promulgation of the stress test, how far away are we? I have been asking now for eight years, and I hope that we are not going to extend the review period unnecessarily. Are we nine months away? A year? Eighteen months away?

Mr. FALCON. Mr. Chairman, I can assure you you won't be asking for another eight years. I can say that safety.

Chairman BAKER. I can assure you that too.

Mr. FALCON. We are in the process of going through the comments we received on risk-based capital proposal and depending on the amount of work that is required in terms of adequately responding to each and every comment that we receive, and we receive thousands of pages of comments on this proposal, we will have to assess how much modification might be appropriate to the rule in response to comments in order to produce the best possible capital rule.

It is my hope, Mr. Chairman, that after going through these comments, I hope that we can get done before the end of the year. I say that at great risk, because I don't like missing deadlines and the agency has missed deadlines before. So, but that is my hope. It all depends on the nature of the comments and the amount of

work that is required to modify the rule in response to the comments.

Chairman BAKER. And let me for the record say all the reasons for delays and unmet expectations do not lie at the feet solely of OFHEO, and I certainly do intend to try to help with the appropriations resolution as best we can notwithstanding the outcome of this legislation.

Mr. Kanjorski.

Mr. KANJORSKI. Thank you, Mr. Chairman. Let me start at the very top.

I think, Mr. Morrison, in your testimony you talked about some people in this town who do not like GSEs, and that there probably is some maturity level that a GSE gets to where it warrants privatization. Does anybody think that we should look at privatizing Fannie Mae and Freddie Mac as we did with Sally Mae? Are we at that level where they are mature institutions? And if we did privatize, would that lessen in any way the implicit full faith and credit support? In other words, would they be too-big-to-fail even if they were private institutions?

Mr. MORRISON. Well, I am not a fan of privatization myself. First of all, we need to be clear on what true privatization actually means. Obviously, all the capital is privately-held today. There are many private aspects of GSEs to start with. But if you could ring out all of the public benefits that are different, you would have two problems.

One, you would also at the same time wring out all the benefits the consumer gets from those lower costs, so you would raise prices in this marketplace. Some people would say that is appropriate, because there is too much emphasis on housing. I don't happen to agree with that. But the other thing you would get is two enormously well endowed enterprises with enormous ability to dominate the marketplace. So you might end up with still having a kind of dualopoly power while you had given up any basis to require any public benefit. That wouldn't seem to be a very good outcome.

So I think a much better approach than privatization is to focus on competition in the delivery of the GSE benefit. That is what we think we are doing with Mortgage Partnership Finance and other mortgage purchase programs: creating a third way of delivering the GSE benefit, which—by bringing a new form of competition—will mean the pricing will be as sharp as it can be, and, therefore, will be most likely to benefit the consumer.

And I think there are other strategies one can pursue to make the "too big" part of the "too big to fail" equation less of a problem. The debt needs of the enterprises, including the Federal Home Loan Banks, can be made less of a problem. That is why we focus so much on the arbitrage issue, because we think that the balance sheet should be used for assets that actually deliver the goods to the consumer.

So I guess what I would say that is the problems are worth considering. Privatization is unlikely to be the remedy that politically or economically will do the most good.

Mr. KANJORSKI. Let me move to the next question then. If we do not privatize, obviously there is an importance with the mission and it seems to me as public policy is concerned, the mission state-

ment of these entities are more than likely determined by who is President of the United States and who is in the majority of the Congress. If we were to create a single regulator and merge the mission control and safety and soundness regulation under one system, would we not be divorcing these entities from the representatives of the people or the President?

Mr. MORRISON. Well, I don't think so. First of all, the Congress ultimately writes the charters. By the same token, nothing Congress writes can ever be precisely tailored to everything that will come afterwards. So, there need to be regulatory interpretations. Whether you have a director or a board there——

Mr. KANJORSKI. What about the independence of that charter?

Mr. MORRISON. Well, if you are concerned—I think independence within limits is what you want. No entity should be independent from the byplay between the Congress and the President.

Mr. KANJORSKI. Well, are we not talking about a structure similar to the Federal Reserve? Is that not somewhat divorced from the influence of Congress?

Mr. MORRISON. I think what is in H.R. 3703 is very similar to the structure of the Federal Housing Finance Board. It is a five-person board. The only real difference is that the Secretary of the Treasury would be joined with the Secretary of HUD on such a board. That is very different from the Fed. We operate certainly under Congressional oversight and we have Executive Branch input today both from HUD and on an informal basis from the Treasury.

Mr. KANJORSKI. I know we never have any difficulty filling these spots on the Board, because we have such great cooperation between the Administration and the Congress, but is competition not likely to happen if we create an independent agency?

Mr. MORRISON. There is no question that filling boards, certainly filling our board, has been an adventure throughout my five years on the board. And that very much might argue in favor of what Mr. Falcon had to say about the possibility of having an independent agency with a single head. All of these choices have up sides and down sides and I don't think any of them is perfect and ultimately it is the wisdom of the Congress that will govern.

Mr. KANJORSKI. I take from your testimony, Mr. Morrison, that if we did not have the GSEs, particular Fannie Mae and Freddie Mac, the private sector would not have, and could not have, an entity as we do today for a real secondary market.

Mr. MORRISON. Well, there is no question that the secondary market would never have been developed to the degree it has without the leadership that came initially within the Executive Branch. Fannie Mae was originally an Executive Branch agency. It was like Ginny Mae is today, a corporation within the Government. And the first securitization really came from there and then Freddie Mac when it was first developed was really very closely overseen by the Federal Home Loan Bank Board.

So in all of these developments, and in what we have today, the private sector has gotten a marketplace with the assistance of the public sector. The question now is to make sure that the public benefit continues to exist from this very well developed market.

Mr. KANJORSKI. I know my time has expired, Mr. Chairman. I just want to ask Mr. Morrison a question that Mr. Gensler answered. Will you cooperate with us as we get an opportunity to reexamine the expansion of the mission for the Federal Home Loan Bank System in taking larger roles in economic development, community development and infrastructure development in the distressed areas of the country?

Mr. MORRISON. Yes, as you know, I personally am very supportive of the Federal Home Loan Banks' taking a much more aggressive role with respect to that kind of economic development. I think the collateral change that you and Mr. Baker were very important in enacting will contribute greatly to their ability to do so.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Chairman BAKER. Ms. Velázquez.

Ms. VELÁZQUEZ. Thank you, Mr. Chairman.

Mr. Apgar, first I would like to thank you and Secretary Cuomo for the time that you have taken with the Hispanic Caucus to update us on your oversight of Fannie Mae and Freddie Mac. In conjunction with HUD's oversight, you have recently expressed concern about Fannie Mae and Freddie Mac's record in helping serve minorities. The housing GSEs argue that H.R. 3703, if enacted, will stifle the ability to develop innovative products and this in turn will hamper their ability to assist minorities in achieving home ownership. Do you think this is a valid argument?

Mr. APGAR. No. I think that there are many opportunities today that exist within the confines of their charter to better serve minorities, low- and moderate-income folks, underserved communities broadly. We propose an aggressive new goal for them to meet and we think within the basic confines of the primary mortgage market and their role as secondary mortgage lenders, there are ample opportunities. We do not believe they need to reach out into new program areas. We do not believe they need to necessarily go into subprime lending or many other areas of expansion in order to meet these higher goals. It is a question of working hard.

I take the GSEs at their word that they have embraced these higher goals and I perceive that over the next couple of years we will see a substantial expansion of their involvement in underserved communities to the benefit of minorities across the country.

Ms. VELÁZQUEZ. Franklin Raines, the Chairman and CEO of Fannie Mae, recently stated that HUD's proposed rules, affordable housing rules, for Fannie Mae and Freddie Mac are tougher than CRA requirements for financial institutions. In fact, he referred to the proposed rules as "CRA requirement on steroids." Obviously, you believe the proposed rules are reasonable and necessary. Could you explain to the subcommittee why that is the case, specifically how will the proposed rule help insure that Fannie Mae and Freddie Mac purchase loans in underserved neighborhoods?

Mr. APGAR. Well, I saw the comment about the "CRA on steroids." All I can say with respect to that is Chairman Raines has also stated many times, including at joint appearances with Secretary Cuomo, that these goals are doable and he welcomes the opportunity to push his company toward expanding their lending in this arena. Again, we have done a careful analysis of the marketplace and we have looked at the kinds of loans that private lenders

are making and there is ample opportunity for Fannie Mae and Freddie Mac to increase their presence in these marketplaces.

We note that both companies have initiated new programs to achieve that and most recently of course Fannie Mae has committed itself to a substantial increase in its lending across the board. So we think it is doable and we welcome working with them to expand opportunities in underserved communities.

Ms. VELÁZQUEZ. If Congress enacted H.R. 3703 into law this year, could that delay HUD's efforts to finalize the affordable housing goal for Fannie Mae and Freddie Mac?

Mr. APGAR. We are very concerned about the timing and the transition. As Mr. Falcon said, there is a major safety and soundness rule underway. There is GSE affordable housing rule in place and we would be careful about the transition period. It is our intention though to have our affordable housing rule finished and in place before the end of the year so it would affect it that way.

But we do believe that HUD has demonstrated its record as being an effective regulator. We believe that—we share the view that Secretary Gensler mentioned that we need to have coordination in the housing policy arena and to the extent to which we have mission regulation it ought to be coordinated with those who are knowledgeable about housing policy and we think that is HUD and Secretary Cuomo I think has demonstrated that capacity to use his authority in the GSE regulations as part of development of an overall housing policy for the Nation.

Ms. VELÁZQUEZ. Thank you, Mr. Apgar.

Mr. Falcon, as you know, this legislation will create a new five-person board combining all the representatives from the current regulatory agencies, but the bill does not integrate the different rules and functions of the current agencies. Doesn't this proposal seem to encourage a confusing bureaucratic situation that has the potential to detract from the safety and soundness activities of the board?

Mr. FALCON. I think it is critical to make this happen properly if it is Congress' will to make this happen that there be an adequate transition period to make sure that you don't run into these types of problems. I believe one of the things that the bill would do would be to require that OFHEO's risk-based capital standard be applied or some variation of it to Federal Home Loan Banks. To try to do that at the same time that you are merging the agencies and trying to put in place a new management structure for the agency would be very difficult and would make it, I think, difficult to properly integrate the different administrative functions, everything from payroll systems to staff and operation of the agencies.

Ms. VELÁZQUEZ. Thank you. I just have one more question, please. Mr. Morrison, the bill under consideration is called the Regulatory Improvement Act. There is no question that the bill will change the regulatory structure for the housing GSEs. The question is whether this change will be an improvement. In your opinion, would this legislation improve on the current regulatory structure, and if so, in which ways? If not, where does this bill fall short?

Mr. MORRISON. Well, I think my sense is that it is the intention of the authors of the bill to improve regulation. I think there are

a number of ways in which what is proposed here could do so. And the aspects of it that I think would be specific improvement are the coordination of policy for housing GSEs in one place. These entities are in the same business. One operates primarily at the primary level and the other two at the secondary level, but they are in the same business and different regulatory policies affecting them lead to unequal results.

And to the extent that they can be coordinated, that will be better. That doesn't mean that the current structure lacks any coordination, because Mr. Apgar serves on the Finance Board and that provides a level of coordination. There is informal communication and coordination all the time among the agencies. So we are not in any crisis. This is really a future-oriented question.

I think that there are risks whenever you make changes in Government organization and you can get a mess. I think Mr. Falcon has been quite eloquent on that point, about what the risks are. So I think the Congress ought to think about this question not in a "What do we need to do tomorrow?" way, but rather "What would we like this structure to look like five years from now? What are we likely to see on those charts in five years?" and "What would we like to be in place?"

And if more consolidation and coordination is your choice, and that would be my choice if I were sitting in your seat, then plot a way to get there so you don't have the down sides. Resolve all of the competing concerns and move in that direction. There is no need to act precipitously. There is no crisis out there. This is about refining something, but no one should underestimate what we are talking about here.

We are talking about trillions of dollars of assets under management in twelve Federal Home Loan Banks and two secondary market enterprises. It is a huge part of our economy and it doesn't look that way when you see three regulators here, each with his hand on one part of the system.

Ms. VELÁZQUEZ. Thank you. Thank you, Mr. Chairman.

Chairman BAKER. Just a little bit of equal time on the question of performance, Mr. Apgar. Ira Peppercorn, your predecessor, appeared before the subcommittee on July 30, 1996 and made a statement with regard to his observations about performance where in that time period of review low income borrowers accounted for 8.3 percent of GSE's purchasers of home mortgages compared to 13.5 percent of mortgages originated by commercial banks.

Underserved neighborhoods accounted for 20.3 percent of GSE mortgage purchases compared to 26 percent of commercial banks. I remember reading something in recent weeks of your comments with regard to the practices of Fannie and Freddie in meeting minority needs. I don't know given the press reports of it how accurate those comments were. Do you stand by what I believe to be your observation about the performance of GSEs and minority lending and is it not in fact a more historic problem rather than just a recent revelation with regard to how they compare with the commercial banking industry?

Can you speak to that, because I know Ms. Velázquez has a real interest in seeing these institutions perform and my point is they might can be doing a little better.

Mr. APGAR. Yes. A lot of the discussion was about their performance relative to the overall banking and mortgage lending in general. The reason we are raising the goal is, because we perceive they can do more, that in fact we see that among minority lending in general they tend to lag the market, but there are particular areas where they lag even more so.

We pointed out in the rule, although I have to admit it is in an obscure table deep in the bowels of the rule that in fact when you look at the overall record of Fannie Mae and Freddie Mac for African American lending and for Hispanic lending both of their share of business in those arenas are less than the performance of banks, thrifts and other mortgage lenders, and so we stand by those facts.

I think our focus on the rule is they can do better. The rule is to encourage them to do better and by all admissions they have committed to doing better so that is looking forward we think where we will be heading.

Chairman BAKER. Just to put a fine point on this, commercial banks over the duration of analysis of regulators looking at percent of portfolio to African Americans have out-performed the GSEs every year for which I have been given data.

Mr. APGAR. That is correct, even up to the most recent period for which we have the data.

Chairman BAKER. Thank you.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman, and let me first of all welcome my fellow Texan, Mr. Falcon, to the panel. I apologize for not being here when you started. And I have to tell you, Armando, it is interesting to sit up here and see a list of questions that we might ask you. I am sure that you never had any opportunity to prepare these when you were staff some time ago, but I am going to stay away from those.

I do want to follow up on the Chairman's line of questioning and also some comments that Mr. Morrison just made. And I don't know if the Chairman is implying perhaps we ought to apply the Community Reinvestment Act to the GSEs to see if they do a better job.

Chairman BAKER. No. I was just merely pointing out that making a $4 billion profit last year hasn't translated into loans to minorities.

Mr. BENTSEN. But I guess you could say that the CRA has had some impact on banks and their lending into minority neighborhoods. Mr. Apgar, obviously we all know that HUD and the Secretary have been engaged in a war of words with the GSEs, particularly with Fannie and Freddie over their minority lending primarily to African Americans and Hispanic Americans. And you have a rule that you are proposing now to increase their targets for that lending.

In your opinion, were Congress to enact the legislation that the Chairman is holding the hearing on today, particularly repealing the line of credit and potential credit market impact that could have on the GSEs, would you view that as being counterproductive to the rule that HUD is proposing at this point in time or do you think the GSEs could swallow both the changes that are provided for in the bill being discussed today and what HUD is proposing?

Mr. APGAR. I would echo Secretary Gensler's comments with respect to the line of credit along with the Chairman. We think it is largely symbolic. We think that its elimination would reinforce what everyone believes to be the case that there is no explicit Government guarantee, but I think that that change particularly will affect their cost of funds and therefore will have no effect, in my opinion, on their capacity to meet the GSE affordable goals.

Mr. BENTSEN. Now it is my understanding, and I thought I had it with me today and I don't though, that one of the rating agencies, I believe it was Moody's Investor Service, had said without this implicit guarantee that is assumed through that line of credit that Fannie or Freddie would go from a AAA to a AA-minus. As I told Mr. Gensler still a pretty good rating, nonetheless that would clearly affect their pricing and affect the pricing of their products, pricing of their debt and the pricing of their products. But you don't think that would have any impact on the targets that——

Mr. APGAR. Well, again I just echo Mr. Gensler's comments that there are other facts in terms of assuring the overall stability of the system that have positive effects and that those would tend to work in opposite directions so again we do not perceive that there is a major issue relative to this bill as relates to achieving affordable housing goals.

Mr. BENTSEN. So from HUD's perspective you would agree with Treasury, Congress ought to go ahead and just repeal that and move away from the implicit guarantee for Fannie and Freddie?

Mr. APGAR. Right. We try to be one Administration and so we share the Treasury's view on the line of credit. They have expertise in that area that far exceeds mine. And again the specific question concerning mission regulation, we don't see a conflict there.

Mr. BENTSEN. Mr. Morrison said we should not act precipitously in this. There is not a crisis at hand, but we ought to be thinking long term, because of the size of the GSEs combined including the bank, the Home Loan Banks. Mr. Falcon's agency has spent the last several years, seven years, I guess, developing a risk-based capital model for Fannie and Freddie, that is in the final stages now at least of the rulemaking procedure and we will by the end of the year I guess get a feel for where OFHEO believes the GSEs are from a creditworthiness standpoint.

Would it be in your opinion, Mr. Morrison, appropriate that we should wait for OFHEO and review that Mr. Falcon is doing with his agency before passing any legislation that would change the overall regulatory structure?

Mr. MORRISON. Well, I don't think you have to necessarily wait, nor do I think you have to necessarily act before that time. Whatever you do, you ought not to interfere with OFHEO concluding its process of finalizing that rule and putting it into effect. Nor should any change similarly affect what we are doing at the Finance Board to write a new risk-based capital scheme for the Federal Home Loan Banks, which is due out by November 12. No change should be managed in such a way to interfere with those goals, which are more important than how the boxes go together in the Government, more important to the safety and soundness of the GSEs.

So does that mean you can't consider the question of what would be the best way in the long run to oversee those capital rules, to bring those capital rules into conformity? They theoretically should be the same, but they can't be, because OFHEO was given a very tight set of statutory rules that they must follow in writing—rules that are different from ours. So five years from now all three housing GSEs should probably have comparable capital rules, but they won't in the short run, and they probably never will if they are not under the same regulatory scheme.

Mr. BENTSEN. Mr. Chairman, with your indulgence, can I just go back real quick to Mr. Apgar? And, Armando, I am sorry to leave you out of all this what my questions are. Are you saying HUD doesn't—Mr. Gensler, if I recall, said that there would be—there is a pricing differential that occurs, because of the rating and presumably without this implicit guarantee. I think this is right that Fannie and Freddie would lose their current AAA rating. Now I don't know whether HUD agrees with that or not. That would be my first question.

But second of all, are you saying that if there was a 30 or 40 basis point pricing differential that that would not have—you all don't believe that would have any material effect on Fannie and Freddie's ability to service the lower income market?

Mr. APGAR. First of all, you presume that there will be a substantial change. He outlines scenarios in which there would be offsetting factors which would mitigate any interest rate change. But again it is a matter of what share of their business is oriented toward low- and moderate-income borrowers. We do not perceive that in many instances affordable lending is any more less the profit-making than mainline business is a question of developing extra business systems, the outreach and the context.

We have done extensive studies on the margins, if you will, that can be earned by doing affordable lending and they hold up quite nicely. So while it may affect their overall business activity their proportion of activity that is devoted to low- and moderate-income folks we don't think it would necessarily be affected.

Mr. BENTSEN. If we cut off their line of credit, why not just cut them off completely and spin them off completely. Let them break up whatever and let them go on and do their business as they will. I mean what connection do we have to them after that?

Mr. APGAR. We perceive that our capacity to encourage them to engage in outreach to low- and moderate-income borrowers is enhanced by their current quasi-Government status. As a purely private entity, we think that they would move even further away from affordable lending than they are today.

Mr. BENTSEN. What quasi-Government status do they have once they have no implicit guarantee?

Mr. APGAR. They have the oversight. They have the safety and soundness reviews. They have an association with the Government from its historical——

Mr. BENTSEN. But in reality, and I don't mean to be argumentative, but in reality banks have the oversight and they have the safety and soundness review, but the only difference would be the long-term association, but the Government would——

Mr. APGAR. And we best be clear, we are talking about securities which on their face say this has no Government guarantee, yet the market perceives that, because of the association of the entity historically with the Government, its Government roots, its Federal oversight through its board structure and other things that they have some guarantee. How that psychology change, because of the symbolic change, I remain to see.

Mr. BENTSEN. Well, I don't completely agree with that, but my time has expired.

Chairman BAKER. Thank you. Let us take the flip side of that just for an observation, a little equal treatment time on the other side here. Why don't we just take the implicit guarantee and make it explicit. If all the benefits that are flowing to the market are good for consumers by having the implicit guarantee and the line of credit to the Treasury, why not just put this sucker in the Treasury Department and say it is a nationalization of home mortgage debt in this country? Why don't we really make mortgages cheap? What do you think about that?

Mr. MORRISON. Would you like an answer?

Chairman BAKER. Yeah, I really would. I mean the logic here is that by having the implicit guarantee, the line of credit, we are doing good things here, we are making home mortgages available to everybody, it is cheap, it is the way to go. Let us just put it on the record.

Mr. MORRISON. As the Chairman knows, we do that with the FHA program and with the VA program.

Chairman BAKER. Yeah, but I am saying let us bring everybody to the party.

Mr. BENTSEN. If the Chairman will yield. The only point that—and the Chairman makes a very good point, and I guess my point is I think we are looking at this bill and not having a discussion about the broader issue before us, which I don't know if this is the intent or not, as to whether or not we are decided that the GSEs have gotten too big and it is time for us to move away from them. And here it seems to me we are maybe taking a back door approach to that. If we are going to have that discussion, let us have that discussion.

Chairman BAKER. I am with you. Let us open all the doors. Let them all come down. Mr. Morrison, would you care to——

Mr. MORRISON. Well, let me make clear that what I am about to say doesn't speak for anybody but yours truly. There is an attempt to somehow shuffle around this implied guarantee question. There is no question that the markets infer a guarantee. That is a fact. Mr. Bentsen is absolutely correct that Moody's has said that they wouldn't give a AAA to Fannie or Freddie if they didn't feel that the Government support was there because of their capital levels and other such things.

So it is there. And it doesn't serve a purpose to pretend that that isn't what is going on in the market. So when you make a decision, whether it be the Treasury line of credit or something else, you are faced with the question of what is the market going to think when you do that. And I think Congress is stuck with the reality. However it came to pass, if various kinds of Government assistance are

removed, that is going to have cost impacts. And you are just going to have to decide which risks you want to take in that regard.

The fact is that when there was a problem in deposit insurance, as there was in 1989, what Congress decided to do was just what you just said, go from that implied backing to full faith and credit. So I suggest if there ever is a problem with GSEs, you could figure out how it is likely to come out. But the real issue is that the concern ought to be the "too big to fail" issue. In other words, what are the taxpayers signing up to and are there ways to run the GSE businesses to stop maximizing the amount of debt and the size of the assets in the portfolio?

And then whether they are "too big to fail" or not, they won't be so big and the taxpayer risk won't be so great. And I think that discussion—which has not been reached yet, but which I know that you and your colleagues are up for—is worth having. When I go elsewhere in the world and talk about housing policy, I find that everyone wants what we have been able to achieve by the sleight of hand of implied guarantees. Everybody asks "How do we get an implied guarantee for our debt so that we can support housing in our country?" The answer that those countries are all given is that "the full faith and credit of your government is the best you can do if you want to replicate this." So the American people have gotten a bargain here. I don't know that anybody ought to want to mess with it, given its success.

Chairman BAKER. Let me characterize it this way. I am a co-signer as long as every other member on Fannie's debt and if that helps get better prices to our constituents, I will co-sign. I just don't want my phone to ring making good on that partial obligation of mine to pay off their debt in case things don't work out right.

Mr. MORRISON. Which is the question of the quality of the regulation that you get.

Chairman BAKER. That is it.

Mr. KANJORSKI. Mr. Chairman, if we are going to get into that issue—and it is not a bad issue to get into, I would like to know the distinction between the implicit full faith and credit support and too-large-to-fail. I do not see a distinction. And, quite frankly, if we are going to open that up, are these multi-trillion dollar banks too large and are they getting an implicit underwriting of the taxpayers? In fact, would we not bail them out as the Federal Reserve did in the Long-Term Capital Management situation?

Chairman BAKER. Let me reclaim regular order here. I started this mess and I apologize, but I just kind of got overcome by some of the arguments.

Ms. Waters.

Ms. WATERS. Let just ask a few quick questions so I can make sure I understand. Mr. Apgar, now Fannie Mae does not originate loans, right? They are originated by lenders, is that right?

Mr. APGAR. That is correct.

Ms. WATERS. Now these lenders can sell the loans or keep them, is that right?

Mr. APGAR. That is also correct.

Ms. WATERS. Some of these loans don't carry any mortgage insurance, is that right?

Mr. APGAR. That is true.

Ms. WATERS. Which prohibits Fannie from being able to take them if they are not insured, is that right?

Mr. APGAR. That is also true.

Ms. WATERS. Now all of this data in this discussion that was in the papers about African Americans, have you seen that data?

Mr. APGAR. Have I seen it?

Ms. WATERS. Do you review the information that Fannie Mae submits and are you privy to what was in the voluminous information for review that is submitted by Fannie Mae?

Mr. APGAR. OK. Now we have to be careful here. With respect to their performance of GSE affordable housing

Ms. JONES. Excuse me. Would you put the microphone in front of your mouth so I can be sure I understand everything you say, please? Thank you.

Mr. APGAR. OK. I am not sure what voluminous data you are talking to. They submit to us very——

Ms. WATERS. OK. What is your role in fair lending enforcement?

Mr. APGAR. I have no role in the fair lending——

Ms. WATERS. You have no role in fair lending enforcement, but you——

Mr. APGAR. I do have a role in reviewing the performance under GSE goals, which includes performance in meeting the needs of underserved communities. The data that was presented in here was not a part of the fair lending review. It is part of our overall oversight of Fannie and Freddie relative to——

Ms. WATERS. So you establish goals?

Mr. APGAR. We establish goals.

Ms. WATERS. You establish goals for African Americans?

Mr. APGAR. No, we do not. We establish goals for low income folks——

Ms. WATERS. Why don't you establish goals for African Americans? You spoke about what Fannie Mae is not doing in relationship to African Americans, did you not?

Mr. APGAR. We did.

Ms. WATERS. Well, if you don't have any goals, what is your role in insuring that African Americans are outreached to or have advantage of getting the Fannie Mae product? I mean what——

Mr. APGAR. Well, the underserved area goal, which is defined by a combination of low income status——

Ms. WATERS. No, I am not talking about underserved. The article was about African Americans.

Mr. APGAR. Well, if I can explain how increasing the underserved area goal will directly benefit minorities. It is proportioned——

Ms. WATERS. No. I said the discussion was specifically about African Americans, and I am really interested in African Americans.

Mr. APGAR. Fair enough. A proportioned large share——

Ms. WATERS. So I want to know why you don't have goals, and if you don't have goals, how do you determine whether or not Fannie Mae is meeting goals?

Mr. APGAR. OK. The goals were identified by legislation as part of the 1992 Act. They prescribed what goals we can impose on them. We track——

Ms. WATERS. On what?

Mr. APGAR. On Fannie Mae and Freddie Mac.

Ms. WATERS. For African Americans?

Mr. APGAR. No. There is no specific African American goal. The Congress in its wisdom concluded it was not——

Ms. WATERS. How do we determine whether or not Fannie Mae is meeting African American goals?

Mr. APGAR. They report to us their information on their lending and we compare their lending to other lenders in the area and we note that their performance among African Americans lag other lenders in the market area.

Ms. WATERS. OK. All right. And that is good. I don't mean to be mean, you know. I am just like this. Let me ask you this. Did you do these kinds of comparisons. Remember when I first started talking the other day, I talked about subprime lenders at mortgage companies with extraordinary fees lending to people in ways that only cause them to be foreclosed on?

Mr. APGAR. Yes.

Ms. WATERS. Now are you putting those in the category of people that you compare Fannie Mae with——

Mr. APGAR. No.

Ms. WATERS. ——who are making these loans in these underserved communities that you think are kind of majority African American?

Mr. APGAR. No.

Ms. WATERS. Who, tell me who these others are that are doing so much better?

Mr. APGAR. Who are these others? The thrifts, depository institutions, others who have presence in African American communities.

Ms. WATERS. Such as? I live there. Tell me. I know something about this. Tell me who they are.

Mr. APGAR. Banks.

Ms. WATERS. Which banks?

Mr. APGAR. I can get you a list.

Ms. WATERS. Bank of America? Nation's Bank? Wells Fargo? Tell me which ones.

Mr. APGAR. Depository institutions in general often in response to their CRA obligations. We can get you a list of——

Ms. WATERS. Did you see the latest information on the seven largest banks that serve Southcentral Los Angles and the number of loans they made in 1999?

Mr. APGAR. I haven't seen the evils of Southcentral. I have seen national data.

Ms. WATERS. If you are comparing, sir, if you are comparing, you ought to know what is being done. CRA activists, Greenlining and the others, Greenlining in particular, came out with a study that showed what the seven largest banks did, in 1999, in Southcentral Los Angeles. Do you know how many loans they made? 49.

Mr. APGAR. OK.

Ms. WATERS. In Southcentral Los Angeles.

Mr. APGAR. I would suggest that they ought to do more lending. Other depository institutions are.

Ms. WATERS. Well, let me suggest something to you. The reason I engage you is this. You know, in some instances—well, we are constantly burdened with the fact that we must struggle to get the best that we can get from all of these institutions. If you were privy

to what happened in the Bank Conference Committee where we were doing banking modernization and the fight that we put up on CRA, then you understand that the African American community, the underserved community, they are not doing well.

They are not being serviced in ways that we think make good sense, but what I don't want you to do, because there is this competition fight between the FM Watch and Fannie Mae people who want to reduce the competition, want to kill off Fannie Mae's ability to do what it is doing, afraid of Fannie Mae expanding, all of that. I don't want you to come in here and point the finger at the only GSE that we have real access to, GSEs who meet with my minority banks and who purchase paper in ways that I don't think others would do.

I again mention to you we have access. I can't get the CEOs of the major banks that own the subprime lending operations. I can't do very much about the mortgage entities that charge exorbitant fees and are foreclosing on my constituents day-in and day-out. So I don't want Fannie Mae to be diminished in any way, because it is responsive. I want them to expand their lending. They are going to try to meet these 50 percent goals.

And so I don't know what this is all about. And I think that Mr. Morrison, I think it is, said it best, no matter what you do, you've got to keep your eye on what is good for the consumer. I don't care about this fight and some may be here, and I am not suggesting you are, because I don't know who is, but I will find out, some may be here trying to protect the so-called participants in the FM Watch.

But, my business is to look out for the consumers. And again, let me just say to you, this information that was unveiled did not take in a lot of the factors such as the ones that I have raised with you about who the banks are selling the paper to, whether or not the bankers are—some of them are keeping it in their portfolios and how the mortgage entities are getting more than I would like to see them with sometimes.

And so this data really doesn't mean an awful lot. What is important to me is that the Government takes an interest in making sure that we keep at this thing of trying to get the underserved communities served. And let me just close by saying these advantages that we keep talking about, we don't talk about the restrictions and when I look at the banks and the thrifts, I see that they have to have—they are under the national charter. The deposits are guaranteed by the full faith and credit of the U.S. Government.

They have access to the Fed window. They have access to the Federal Home Loan Bank advances. Look, they are all covered in some way. They are all covered in some way. They are all connected to the Government in some way. We are guaranteeing. And so let us not try and pretend.

Chairman BAKER. Can you begin to conclude?

Ms. WATERS. Well, I guess I must, but——

Mr. APGAR. Mr. Chairman, if I could make just a reaction to——

Chairman BAKER. If Ms. Waters has wrapped up. Ms. Waters.

Ms. WATERS. Well, let me just conclude by saying I am particularly addressing myself to you, because of your role in the discussion about loans to African Americans by Fannie Mae, and I par-

ticularly took a look at what your role was and what your involvement is and tried to make a determination about whether or not you had the facts and you had the data, you had the information. And I have come to the conclusion that there was a lot that was not discussed in coming to this conclusion. Thank you.

Chairman BAKER. Thank you, Ms. Waters.

Mr. Apgar, I know you wish to respond. Let me bring up one set of facts, which I believe you did make available in your defense. If I am correct, your observation is that approximately 5 percent of the conventional mortgage market, not the subprime lenders——

Mr. APGAR. Subprime, correct.

Chairman BAKER. We are talking about traditional banks and financial institutions. About 5 percent of the conventional mortgage business went to fund loans for African Americans. In the same timeframe approximately 3.2 percent of Fannie Mae's loans went for African Americans' purposes, while 3 percent of Freddie Mac. Now can you speak to Ms. Waters' concerns and address the points I have just raised?

Mr. APGAR. Yes. You just read the numbers off of my chart, which I was about to state and then the issue is what is this performance. I believe it is not for lack of trying. I know there is great leadership in both companies in trying to work on this, particularly Fannie Mae. But again, the idea that they are captives of the primary market I think is not correct to say.

I would be happy to come work with you and show you the names of many people who would sell loans to them and enhance their service to African American communities if they were allowed the flexibility of the underwriting that they think would help them make these business connections. So there are many mortgage insurers and others who would be able to expand their outreach in the African American communities if Fannie Mae and Freddie Mac were more flexible in their underwriting circumstances.

With respect to banks and thrifts, there are many banks who have portfolio loans which they would like to recycle if they could get favorable terms for Fannie Mae and Freddie Mac in order to buy those loans. That would free up capital to expand their lending in minority communities so it is not a question of them doing nothing, it is a question of can they do more and by all agreement we think they can do more. And Chairman Raines and Leland Retzel have agreed that they could reach out and do more. That is why they have embraced the goals and that is why we think we are moving forward in a solid direction.

Chairman BAKER. If I can, let me suggest this proceeding for us. We just had bells. Mrs. Maloney and Ms. Jones have been very patient and waiting. Can I call on Mrs. Maloney now for a full five minutes. That will give us down to the five-minute bell and then just a quick wrap up and we will be happy to let you go.

Mrs. Maloney.

Mrs. MALONEY. Fannie Mae and Freddie Mac have been tremendously successful in the district that I represent and really in New York City in providing loans for all kinds of people. They have really helped to grow home ownership, which I feel is an important social goal. But one of the things about the bill that I have a question about is the approval of new GSEs program.

And to give one example, I approached Fannie back in 1998, because I don't have homes in my district. Everybody lives vertically. They are either in an apartment or a co-op or condominium. I said, "You are doing great things to help Harlem and Historia and other areas of the city." Actually, Historia is in my district, but East Harlem used to be in my district and they were providing all kinds of loans there. I said, "But you are not doing anything for the low-income people in Central Manhattan."

Within six weeks, they came back and devised a program to provide loans for co-ops and condominiums and have proceeded to grow home ownership dramatically. And to tell you the truth, I was very impressed that they had that type of flexibility to come back with a program that was really tailored to the economic problems or challenges of the district that I represented.

And my question is, when you change the new products and put them not under HUD, but under this new regulatory agency or whatever it is going to be, this new regulator, and then you add 120 days to make such determinations, I am concerned that you wouldn't have the same type of flexibility and quick market response. What if this new regulator said, "Oh, no, we don't think you should be giving loans to co-ops and condominiums."

So, I just want to ask about that. And the oversight now—or rather the approval of new programs, seems to be working fine now in HUD, is that not true?

Mr. APGAR. Yes. I think——

Mrs. MALONEY. So why have this change, why have this change to this other regulator?

Mr. APGAR. The example you give is in the arena that you suggest, the mortgage lending condominiums or cooperatives, that is clearly within the four quarters of this charter and would not require new program review. The new program authority is when they begin to venture outside of traditional boundaries of their activities, engage, for example, the sale of distressed properties, engage in home equity lending or other types of activities that are different from the mortgage lending.

And I do share with you the concern that we don't want to make this process cumbersome and so I think all the commentators suggested that maybe the notice and comment feature of the rule as the legislation has specified may limit the flexibility to respond quickly and that would not be the desired effect. But clearly there has to be some mechanism to establish whether or not, given their advantages in the marketplace, they are sticking to this focused arena of expanding home ownership opportunity.

Mrs. MALONEY. But, doesn't HUD have a review now? How long does it currently take HUD to complete reviews of new programs, and are there any problems that necessitate such a change now?

Mr. APGAR. We do have the current authority to review new programs. What we don't have is any requirements that they alert us ahead of time before they initiate a new program and so, quite frankly, we read about new activities in the paper and then we begin to inquire. We think there should be some clarification of the obligation of the GSEs to notify us when they are considering a new activity and give us at least a preliminary chance to review that before going ahead with a yea or nay.

But in the case that you suggest that the condominium lending, triple-decker lending are all kinds of things within the clear mandate of providing mortgage capital that would challenge either ours or any perspective new program review authority.

Mrs. MALONEY. Who is here from OFHEO, Mr. Falcon? What steps is OFHEO taking to ensure that taxpayers will not be asked to salvage insolvent GSEs?

Mr. FALCON. We have a very, I think, state of the art capital in the works, as well as our examination program. I think our examination program look at every possible aspect of the enterprises, market risk, interest rate risk, corporate governance of the enterprises——

Chairman BAKER. I hate to intercede, but begin to wrap up, because I want to make sure Ms. Jones gets her opportunity if you can.

Mrs. MALONEY. OK. Well, I tell you, Mr. Chairman, you said let everything hang out there. Why not expand the mission to include Kiddie Mac? They have been successful in home ownership. Maybe they can do the same for day-care and help the building of day-care which is so desperately needed throughout our country. Seriously. I mean I know that is a goal that you support. Maybe that is something we could look at.

Chairman BAKER. I would bet if this legislation moves forward, you would have people mighty willing to talk about it.

Ms. Jones.

Ms. JONES. Unfortunately, I missed my first opportunity because we had a vote and when I got back you were on to the next panel so I would ask unanimous consent to include my opening statement in the record, Mr. Chairman.

Chairman BAKER. Absolutely.

[The prepared statement of Hon. Stephanie Jones can be found on page 143 in the appendix.]

Ms. JONES. We wouldn't be here, Mr. Apgar, Mr. Falcon and Mr. Morrison, if Fannie Mae wasn't doing a heck of a job, Freddie Mac, and they are out in the market doing wonderful things. Talking about too-big-to-fail, correct?

Mr. APGAR. They are doing remarkable things in the marketplace.

Ms. JONES. And the question I asked you was, we would not be here discussing too-big-to-fail if they weren't doing such a great job. That is a yes or no?

Mr. APGAR. They are big. Yes, that is part of the hearing purpose. I believe we would be here anyway——

Ms. JONES. Mr. Falcon.

Mr. APGAR. I am sorry.

Ms. JONES. I don't have much time, so I am taking short answers. Mr. Falcon, is that correct?

Mr. FALCON. Yes, they are well-run, healthy companies.

Ms. JONES. Mr. Morrison.

Mr. MORRISON. And the same is true of the Federal Home Loan Banks.

Ms. JONES. The GSEs, excuse me. I didn't mean to leave everybody else out, but it made my question much shorter. So here we are, we've got three GSEs doing a great job and we are deciding

now that regulation is the important thing to do, because we are afraid we may end up like we were in the thrift situation. Yes?

Mr. APGAR. Yes.

Mr. FALCON. Yes.

Mr. MORRISON. And they are growing much faster than the thrifts.

Ms. JONES. OK. And they are growing much faster, but as of yet their performance has been wonderful, yes?

Mr. FALCON. Yes.

Ms. JONES. Yes?

Mr. APGAR. Not in affordable housing——

Ms. JONES. But my question really is—I am laying a record, because——

Mr. APGAR. That was a no for me.

Ms. JONES. ——because all these questions——

Mr. MORRISON. I think you are going to have to let us answer and the answer is they could do better.

Ms. JONES. I don't have—the answer is that they are doing a good job. My next is they could perhaps do better, but right now they are doing a good job, yes, Mr. Morrison?

Mr. MORRISON. They could do better.

Ms. JONES. OK. Well, unfortunately I don't have enough time to do my great cross examination of you, so I am going to leave you alone and move on to something else. I am concerned, because as we talk about how Fannie Mae gets in the position to buy the flexibility of underwriting and you raised the issue that they ought to be more flexible when they are underwriting and have more favorable terms to purchase other people's mortgages, is that correct?

Mr. APGAR. That is correct.

Ms. JONES. I sat in my office, for the record, I am the Chair of Housing for the Congressional Black Caucus. I am from the City of Cleveland and the 11th Congressional District of Ohio, and I sat in my office with Fannie Mae representatives and a representative's metropolitan strategy group and discussed the very issue you are discussing. And one of the things that was raised by the Fannie Mae representative is, if it is a home loan that does not have mortgage insurance, Fannie Mae can't buy that, fair?

Mr. APGAR. That is correct.

Ms. JONES. Do you think that could be a factor in the amount of purchasing that Fannie Mae does from certain companies?

Mr. APGAR. If it is a low down payment mortgage they need to have some form of credit enhancement. My sense is that they can enhance their flexibility and enable them to have more——

Ms. JONES. Answer the question. The question was, do you believe that could be a factor in determining whether or not Fannie Mae would have a better record in purchasing some of those loans since they do not have the mortgage insurance?

Mr. APGAR. It could be.

Ms. JONES. Thank you. What did you want to say?

Mr. FALCON. I simply want to make the point, Congresswoman, that mortgage insurance is one of only three credit enhancements that is required for mortgages to be purchased which have a loan valuation of greater than 80 percent. If it is below 80 percent mortgage insurance is not required.

Ms. JONES. Let me also say that I would encourage Federal agencies to not be in the newspaper pointing fingers at one another about issues that impact affordable housing in our communities, because when it happens like that it puts a bad face on all Federal agencies, and as we sit here pointing fingers at Fannie Mae. As much as I love Fannie Mae and Freddie Mac, the people in my community are more distressed as a result of HUD having properties in our community where they have been administered by poor landlords and then the landlords drop a property back on HUD and HUD can't find another buyer.

And you know the property I am talking about in the City of Cleveland, Mr. Apgar, and I am still waiting to hear about that. So let us not get in the public pointing fingers at who is doing a good job or who is doing a bad job. Let us talk about how we can do a better job and increasing affordable housing in communities across the country. I yield the balance of my time, Mr. Chairman.

Chairman BAKER. Thank you very much, Ms. Jones.

I am going to sum up very quickly. I appreciate all of your courtesies and participating. I would point out that H.R. 3703 contains eight legislative proposals, of which three have been the subject of discussion in the course of today's hearing with representatives of OFHEO, the Federal Housing Finance Board, HUD, and the Under Secretary of the Treasury.

I take great comfort in the fact that there is some meritorious content in this legislation and would point out that the GSEs can do better, not only from a mission compliance perspective, but from a safety and soundness perspective although all three are well funded, well capitalized and we believe are being operated very safely. This legislation is about the future. And for those who do not wish to even look, I am frankly shocked. For those who do not wish to know the facts, I am rather perplexed.

I think that the discussions that I propose to have over the coming months will shed more light on what should be the appropriate course of action for this Congress and this subcommittee to take. I am committed to make sure that taxpayers are not at the end of a long dark tunnel that leads to their requirement to pay off debts of investments they had no hand in.

Likewise, I want to make sure that we do not inadvertently make sure that the cost of housing goes up. I think the two are not mutually exclusive. I think we can have sound regulation, affordable housing and we can allow the GSEs to engage in new products as they deem appropriate. But to fail to take on this obligation and to stick our head in the proverbial sand and wait for the inevitable to occur will not happen on my watch. Thank you.

Ms. JONES. Mr. Chairman, I can't allow you to end the hearing with saying that that is what Members on the other side of this subcommittee are doing.

Chairman BAKER. No, I am not saying the other side. I am saying——

Ms. JONES. Members on the other side of the subcommittee don't have their heads in the sand.

Chairman BAKER. If the gentlelady will——

Ms. JONES. I didn't interrupt you, Mr. Chairman. I am saying to you that——

Chairman BAKER. I know, but the reason why——

Ms. JONES. Members on this subcommittee do not have their heads in the sand and they are not saying that regulation isn't important, but they are saying that why do you need regulation when you don't have a dilemma? And I just want the record to be clear that our heads are not in the sand, Mr. Chairman.

Chairman BAKER. I don't know where they are, but I will tell you this, Members on both sides——

Ms. JONES. Mine is on top of my head.

Chairman BAKER. Members on both sides have their observations about this legislation and I am entitled to mine, Ms. Jones.

I am sorry she had to leave. I would like to continue this on, but for the sake of winding this up, I appreciate your courtesies, your input. It has been most helpful and I am convinced we will come to a favorable legislative conclusion. Thank you very much.

[Whereupon, at 2:30 p.m., the hearing was adjourned.]

H.R. 3703—HOUSING FINANCE REGULATORY IMPROVEMENT ACT—PART 1

TUESDAY, MAY 16, 2000

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES AND GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON BANKING AND FINANCIAL SERVICES,
Washington, DC.

The subcommittee met, pursuant to call, at 9:30 a.m., in room 2128, Rayburn House Office Building, Hon. Richard H. Baker, [chairman of the subcommittee], presiding.

Present: Chairman Baker; Representatives Leach, ex officio, Manzullo, Ryan, Sweeney, Biggert, Terry, Toomey, Roukema, Royce, Paul, Cook, Riley, Kanjorski, LaFalce, ex officio, Bentsen, Sandlin, Waters, C. Maloney of New York, J. Maloney of Connecticut, Hooley, Mascara, and Jones.

Also Present: Representatives Watt and Clyburn.

Chairman BAKER. The hearing will come to order. I want to facilitate the progress of the hearing this morning. I do not want to unnecessarily keep our witnesses here all day, as I know there are many questions.

Despite what my staff told me, I always knew that a good, robust discussion of systemic risk would be a crowd-pleaser, and I am glad to see so many of you here. I would like to outline the process. I consulted with Mr. LaFalce about limiting opening statements to three minutes. We will adhere strictly to the five-minute rule. And on our side, I will recognize Members by the order of arrival to the subcommittee.

I would look to Mr. Kanjorski, who I understand is on his way momentarily, to give the order of recognition on his side. And it is without any objection; that will be our process for the hearing this morning.

And the opening statement time is three minutes, so you can start the clock on me if you like.

This is a very important hearing. It literally is a battle over huge fortunes. And I do not mean *FM Watch* v. *GSE Shareholders*. I speak to the potential liability of taxpayers if everything is not run perfectly. The potential for systemic risk is enormous.

Circumstances today appear great for the GSEs. They are well managed, extremely profitable, all is well. But it is my responsibility, and I do believe that of Congress, to ensure that adverse business conditions do not bring on circumstances that could result in economic loss.

In 1992, when Congress created OFHEO, the agencies were large and complex. Today, they are very large and very complex, yet OFHEO is still pursuing implementation of the stress test to gauge agency capital adequacy. Should we wait another decade to initiate sound regulatory oversight? What are we to say to our grandchildren and those who follow when GSE paper has replaced Treasuries as the benchmark for financial transactions, when every bank and pension fund has enormous investment in securities, and housing demand goes down while interest rates go up?

No Government Sponsored Enterprise should be above examination. To have suggested that holding a hearing was to result in 206,000 families being denied home ownership is about as reckless as it gets in my opinion. I wonder how many hundreds of thousands Chairman Greenspan will impact with his expected announcement this afternoon? And should we expect the same criticism to be leveled at the Federal Reserve? I don't think so.

This is an important process, and I emphasize "process." There will be more hearings. Everyone that wants to be heard will be heard, and we will be in no rush to judgment. Many responsible voices have already supported this legislative effort. I want to express my appreciation to the Home Loan Bank system for their constructive approach and willingness to support legislation with appropriate modifications. I want to also express appreciation to the management of Freddie Mac, who have engaged in discussions over the past weeks and have given concrete suggestions that could lead to consideration of legislation.

I also want to express my appreciation to HUD and the Treasury, both of whom found elements of the bill worthy of support, but again, with modification. These opinions were issued also under very harsh criticism.

This is a process, a process that will result in legislation, legislation that will ensure stability over the long haul for the secondary market. But most importantly, the legislation should do all that is possible to minimize potential of systemic risk. At all costs, I do not want a Fannie benchmark or a Freddie security to go the route of an LTCM investment. It is a far more important issue than shareholder return. If one of these big guys stumbles, they will crush us all.

[The prepared statement of Hon. Richard H. Baker can be found on page 196 in the appendix.]

Chairman BAKER. Mr. LaFalce.

Mr. LAFALCE. I thank you, Mr. Chairman. I am only an ex-officio Member of the subcommittee, and I appreciate the opportunity to make a few remarks at the opening of the hearing.

Two out of three Americans own their home today. That is a record home ownership rate. And this tremendous success story is in no small measure a result of governmental initiative in fostering strong mortgage markets through the creation and maturity of FHA, Fannie Mae and Freddie Mac, and the Federal Home Loan Bank system.

As we discuss legislation that proposes to fundamentally reform our Federal regulation of GSEs, specifically Fannie Mae, Freddie Mac, and the Home Loan Bank system, I believe it is critical that we do not either intentionally or inadvertently harm our very suc-

cessful mortgage markets which are the envy of the world. We are barely into the new regulatory regime we put in place in the 1992 GSE Act, and the GSEs have been both successful and effective.

Clearly, nowhere near a consensus exists with respect to the issues raised by H.R. 3703. I think it would be inappropriate and unwarranted for Congress to take any action this year. I think that the hearings are important, but they should not be followed by a rush to judgment and any quick markup.

At the same time, I believe it is always appropriate for our subcommittee to discuss the vitally important issues attendant to GSEs. In spite of the most explicit Federal warning, the GSE debt is not backed by the full faith and credit of the Federal Government. We have an obligation to continuously assess any potential risk that these institutions take, balancing any proposals to reduce risk with any potential negative impact on consumers.

Fannie Mae and Freddie Mac are a demonstrable source of affordable fixed-rate mortgage loans in the conventional market. The Federal Home Loan Bank system provides liquidity and reduces interest rate risks to enable our financial institutions to make affordable fixed-rate loans. Combined, they provide reassurance that mortgage credit will be readily available through good economic times and bad, through both strong and weak credit markets.

There are a number of issues for consideration as we ponder this in the future. First, what is the best regulatory structure? The bill before us would envision a fundamental alteration in our regulatory structure. Without prejudging this issue, I would simply say that our public policy objective should be to have the most professional regulatory staff, as free as possible from political inference and influence, including not being subject to the annual appropriations process and committed first and foremost to protecting the taxpayer.

The second issue relates to the controversy swirling around the so-called “implied guarantee.” Again, without getting into the pros and cons of this issue, there is an explicit statement in the law and in every offering made by the GSEs that there is no guarantee, and I believe our primary responsibility should be to ensure strong regulation so that the issue of the Federal Government ever having to step in is moot, remote indeed.

And finally, there is no escaping the fact that there is an emerging concern on the part of competitors over the scope and activities that GSEs, and Fannie and Freddie in particular, are engaging in. We need to balance the concerns of these competitors against the benefits to the consumers of GSE involvement.

I will confess a prejudgment on this. I am sympathetic to Fannie Mae and Freddie Mac involvement, for example, in the subprime market, provided their risks are quantifiable and done in a safe and sound manner and there are proper capital reserves.

As predatory lending abuses proliferate, and as some of us in Congress have initiated legislation to curb these abuses, I believe there is great potential for Fannie Mae and Freddie Mac to provide affordable mortgage credit to families and individuals with blemishes on their credit record. It is arguably better to have these lenders, who promise to adhere to non-abusive lending guidelines,

making loans to consumers than to have more questionable lenders do so.

So I look forward to today's and other hearings on the GSEs, but I urge our subcommittee to tread most cautiously before reaching any conclusions or before even considering legislative action.

I thank the Chair very much.

Chairman BAKER. Thank you, Mr. LaFalce.

I would restate the rule for the purpose of the hearing today, since Members have arrived after we started. There was agreement to limit opening statements to three minutes. We will abide by the five-minute rule, and Members will be recognized on both sides by the order of arrival at the hearing.

Mr. Kanjorski has agreed to that for recognition on his side as well.

I would like to recognize at this time cosponsor of the legislation, H.R. 3703, and Chairman of the full committee, Jim Leach.

Mr. Chairman.

Mr. LEACH. Thank you, Mr. Chairman. I appreciate your leadership on this issue.

Let me just stress that from a congressional perspective, it is clear that caution has to be the watchword. But there can never be intransigence if it is the status quo that is precipitating radical change in the marketplace. I think we are all going to have to be cognizant of the fact that GSEs were set up to serve and complement the market and not become the marketplace itself; and for that reason, I personally think Congress is going to have to be very vigilant to assure that Fannie and Freddie stick exclusively to the home mortgage market, that the Farm Credit system and Farmer Mac stick exclusively to agriculture, and that the Federal Home Loan Banks make advances to member institutions, rather than loans or equivalents in their own right.

I have three very precise concerns this morning. One relates, again, to the arbitrage activities of all of our GSEs, and particularly Freddie Mac and Farmer Mac, as well as the totality of the Federal Home Loan Bank system. And the argument for liquidity is not a very powerful argument in the case of the volume that is currently taking place in arbitrage activities in these institutions, which I believe is an abuse of public powers.

Second, I am very concerned about the Federal Home Loan Bank system and the movement to reduce capital. Now is a time to be concerned for adequacy of capital, not to reduce it to 3 percent. The fact that Fannie Mae and Freddie Mac have weaker capital standards than commercial banks is no excuse for the Federal Home Loan Bank system to weaken its capital; and in some regards the movement is to a weaker standard than Fannie and Freddie, which I think is very, very dangerous at this time.

And, finally, I would stress within the Federal Home Loan Bank system that the new draft rules on stock tradability lack any restraint on concentration. And what is prospective with these new draft rules is the prospect or the possibility that a single entity could come to control a Federal Home Loan Bank, which I think would be highly undesirable. This could take a cooperative system and make it the captive of a single institution, whether it be a bank, an S&L, or a division of an investment bank or an insurance

company. Even though it is not contemplated by statute, I guess conceivably Fannie or Freddie could buy a Federal Home Loan Bank; and I would stress the frightfulness of that prospect, because Federal Home Loan Banks don't pay Federal tax, Fannie and Freddie do not pay State taxes, both of which are presumptive and powerful circumstances. And if you could balance the two, it would be a real tax umbrage, let alone power play, in the marketplace.

So with regard to stock tradability, in the strongest possible way I would call upon the system to think very carefully about putting limits on what entities can control, or if any entity can control more than a very modest percentage of stock.

I thank you very much, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Chairman.

Mr. Kanjorski.

Mr. KANJORSKI. Thank you very much. Thank you for the opportunity to speak briefly before we begin the second hearing on H.R. 3703, the Housing Finance Regulatory Improvement Act.

In our last meeting in March on this legislation, we heard from the present regulators for the housing Goverment Sponsored Enterprises, or GSEs, as well as the U.S. Department of the Treasury. During my opening remarks at this hearing, I noted that we should move forward cautiously in considering this bill. This will ensure that we maintain the delicate balance that has led to 67 percent of U.S. families owning their homes.

Another issue that I raised in my March statement was consideration of the effect on the marketplace of these hearings. As noted in the *Wall Street Journal* and other news sources, our capital markets experienced disruptions in which the cost of funds for Fannie Mae, Freddie Mac, and the Federal Home Loan Banks increased in the days following our initial hearing. According to these accounts, the spread, or the difference in yields between GSE debt and ten-year Treasuries, increased by as much as 14 basis points. Spreads on mortgage-backed securities guaranteed by Fannie Mae and Freddie Mac also grew wider.

As we proceed today, we must renew our efforts to ensure that we do not accidentally raise home ownership costs.

Mr. Chairman, as I indicated in my letter of March 31 to you, we should not move precipitously on this complex and important set of policy issues by attempting to legislate in the 106th Congress. We should instead continue to use H.R. 3703 as a focus for our oversight activities.

In the weeks following our last hearing I have also had the opportunity to meet with many of the parties affected by this legislation, including those who support, those who oppose, and those who remain neutral on the bill. During these discussions, I have heard many reasons for and against moving ahead. Many of the arguments for and against the bill appear credible when made on their own merits or without someone testing their basis. In my opening remarks at our last hearing, I suggested that we should convene a roundtable discussion with the interested parties. This will allow us to better understand the need for and the implications of this legislation on our housing finance system.

I still believe that a roundtable discussion is the most appropriate forum for our consideration of this issue. A roundtable dis-

cussion would force the participants to challenge each other's assumptions and assertions in an open environment. It would also provide us with greater insights than would testimony that has been vetted and sterilized through the clearance process.

A roundtable debate would further allow us more fully to educate Members about the substantive issues involved in this debate. In addition, it would address the real effects this legislation would have on the housing and finance marketplace.

In closing, I hope that as we continue to consider these important issues, you will join me in working to lower home ownership costs. I also hope that for our next hearing you will invite all interested parties to participate in a roundtable debate. That way, we can have a free, fair, and vigorous deliberation on the future role of GSEs in our housing finance system.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 208 in the appendix.]

Chairman BAKER. Thank you, Mr. Kanjorski.

Does any other Member desire—Mr. Ryan.

Excuse me; I am going to break my own rule. It ought to be Mr. Riley first and then you.

Mr. Riley.

Mr. RILEY. Mr. Chairman, in the interest of time, and I think we have got a lot of people who would like to ask questions today. I will save my comments for later. Thank you.

Chairman BAKER. Thank you, Mr. Riley.

Mrs. Maloney.

Mrs. MALONEY. Thank you, Mr. Chairman, for calling this subcommittee to meet to review issues relating to the U.S. mortgage finance system, the most successful of its kind in the world.

At our last hearing in March, FHFB Chairman Bruce Morrison made the important point that other countries have had great difficulty in attempting to duplicate the success of a United States mortgage finance system. Outside the U.S., fixed-rate, long-term mortgages are a rarity. In the United Kingdom down payments of 20 percent are required and interest rates vary as lenders' borrowing costs change. Lenders in France routinely require 30 to 40 percent down on fixed-rate loans. Japanese loans are made at subsidized rates with down payment requirements of 40 percent.

I believe the goal of this subcommittee should be to make further improvements in the U.S. mortgage market and build on the success of the housing GSEs. I would like to see Fannie and Freddie have the authority to buy child care loans. This is an area where there is a market failure similar to that that Fannie and Freddie solved in housing.

We really must tread carefully to avoid any unintended consequences. Unfortunately, it would appear that certain comments from the subcommittee's March hearing had the effect of increasing spreads between Treasuries and GSE debts. It is vitally important that markets be reassured that we are moving slowly and thoughtfully.

This is not to say that the home mortgage market could not be improved. Certainly efforts to combat predatory lending are worthy topics for the subcommittee. We should also be working to increase minority home ownership rates.

At an appearance last week at the National Press Club, one of our witnesses, Fannie Mae Chairman Franklin Raines, acknowledged that red-lining sometimes still occurs, saying that it is a result of too few lenders competing for business in minority communities. When the chairman of Fannie Mae, whose company benefits from buying loans, says there are too few competitors in a potential market, I believe the Banking Committee should investigate the reason for this market disconnect.

Mr. Chairman, our mortgage market is far from perfect, but we must be very careful not to make changes where it works very well unless we can be certain that there is a real problem with a workable solution that does not generate negative unintended consequences. Thank you very much.

Chairman BAKER. Thank you.

Mr. Ryan.

Mr. RYAN. Mr. Chairman, I first would like to say how much I appreciate your holding this series of hearings. Addressing the tough questions raised by Government Sponsored Enterprises has not been an easy task, and you have done this Congress a great service, I believe, by treading where very few have been willing to go.

In my view, these issues we are discussing today are probably the most important issues we in the Banking Committee will be addressing the remainder of this Congress and most likely in future Congresses. We find ourselves at a turning point in the financial markets. The volume of U.S. Treasury debt in capital markets is falling, and the volume of debt issued by Fannie Mae and the Freddie Mac and the Federal Home Loan Bank has increased to the point where Treasury Under Secretary Gensler stated to this subcommittee that: "GSE involvement in the credit market is approaching the size of the Treasury market." The Treasury now testifies that GSE debt may surpass publicly-held marketable Treasury debt in the next three years.

When Congress created these GSEs decades ago, I doubt that anyone thought that they would reach the point of matching the U.S. Treasury debt in the markets. It is now the responsibility of Congress in 2000 to determine what this means for our country and the future obligation of taxpayers.

In our view, the GSE issue is a very complex one. Fannie Mae, Freddie Mac and the Federal Home Loan Banks have played a vital role in creating the housing market from which all of our constituents have clearly benefited. All of us support a vibrant housing finance system for working families. In fact, I think it is very important at the outset to say that just because some questions have been raised as to some aspect of GSE operations, it does not mean that they are against home ownership or want to raise its cost. Likewise, we should not assume that anyone wants or plans a taxpayer bailout of a GSE. Let us all assume that everybody in this debate is acting in good faith and with the best interest of home buyers and taxpayers equally at heart.

The reason I think these hearings are so important is that the issues involved do not lend themselves to simple or easy answers. In Fannie Mae and Freddie Mac, we have giant, shareholder-owned companies that are now, the two of them alone, bigger than the en-

tire thrift industry. The Federal Home Loan Banks are cooperatives, but their members are private companies too. As these agencies issue more and more debt, we need to be asking serious questions about the benefits they receive, the benefits they pass on to home buyers, and the risks they pose to taxpayers.

I do not know yet what Congress should do, if anything, but the one thing I do know is that this is an important issue with serious implications for home buyers and taxpayers alike. I think the Chairman's bill has properly put this issue on the agenda, and I look forward to a careful and comprehensive review of GSEs today and into the future.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you very much, Mr. Ryan.

Mr. Watt, did you choose to make a statement?

Mr. WATT. No. I thank you, Mr. Chairman. I am not a Member of the subcommittee. I just came to listen. So I do not have any comments.

Chairman BAKER. Thank you very much, sir.

Any other Member desire—Mrs. Jones.

Mrs. JONES. Thank you, Mr. Chairman. Good morning, Chairman Baker, Ranking Member Kanjorski and Members of the subcommittee. I ask unanimous consent that this full statement be included in the record.

I would like to associate myself with the comments of my colleagues, Mr. LaFalce and Mr. Kanjorski. We are here this morning to discuss H.R. 3703. The sponsors of this bill suggest that it is designed to improve regulation and supervision of the housing GSEs. It is my hope this morning that we will be able to discuss the issues surrounding this legislation and the challenges that it presents, not singularly to GSEs, but to the ability of future home buyers to secure homes and for others to obtain affordable housing.

Housing, we know, is a key public policy concern. It was a concern in 1968 when GSEs were formed and it is a concern even today. In cities and suburbs nationwide, there is still an affordable housing crisis. There are citizens, including the ones in the 11th Congressional District of Ohio, which I represent, that are struggling with skyrocketing rents as well as inadequate housing stock. GSEs were established to address this problem.

And it is not as if Congress has not done anything since 1968 to regulate them. In 1992, we passed the Federal Housing Enterprises Financial Safety and Soundness Act that mandated Fannie Mae and Freddie Mac, I quote: "to lead the mortgage finance industry in making credit available for low- and moderate-income families." From my understanding, they are fulfilling this mission; thus, I am glad that we have representatives from these three GSEs to be able to make their own case.

I applaud the Members of this subcommittee for providing an opportunity for a balanced view of the issues surrounding this legislation.

Let me be clear. I need to correct the *National Journal* statement relative to my legislative position. I support affordable housing and increased home ownership, be it Fannie Mae, Freddie Mac, mortgage lenders, and so forth, and I want home ownership for all Americans.

I questioned at the hearing the last time we were here one agency's questioning another with regard to the effect they have on home ownership in America. I am proud to be an African-American, but every time I open my mouth, I do not just speak for African-Americans. I represent a congressional district that is very diverse, and everyone needs housing.

I realize that putting a family into a home is much more than originating a mortgage, automated underwriting systems, or implicit or explicit relationships. Putting a family into a home provides a family with, in many instances, its first real asset or even provides a legacy for future generations. Home ownership, I believe, is one of the first key steps to true empowerment. Thus, we cannot take this process lightly or this legislation lightly.

As our Nation transforms itself from industrial base to an information technological power, we, as Members of the subcommittee, have championed public-private partnerships as well as market innovation; and I sense we have taken a different approach with respect to GSEs.

I have a lot more that I would like to say. I will leave the rest for my questioning. Thank you.

[The prepared statement of Hon. Stephanie Jones can be found on page 205 in the appendix.]

Chairman BAKER. Mr. Sweeney.

Mr. SWEENEY. I will also seek to have my full statement entered into the record.

Let me just say this. I was not here for part of the past deliberations in 1992, when the charter revisions were last made; and I recognize, as I did at the last hearing in March, our need for oversight in this area, and I will reiterate that I am hesitant to conclude that congressional action or reforms are needed at this point in time.

But I want to thank the panelists for being here. I thank those on the panel who have worked with us since last March to begin to develop some constructive ideas, and I think we are developing some constructive ideas, and I look forward to your testimony. Thank you.

Chairman BAKER. Thank you very much, Mr. Sweeney.

[The prepared statement of Hon. John E. Sweeney can be found on page 211 in the appendix.]

Chairman BAKER. Ms. Waters.

Ms. WATERS. Thank you very much, Mr. Chairman and Members.

Well, I suppose it is usually in order to congratulate the Chair for holding a hearing. I cannot do that this morning. As a matter of fact, I am a little bit agitated about the fact that we are here.

While I recognize that there are many, many problems that confront us that we must deal with as public policymakers, I do not take kindly to being basically used in a market share war, where all of us make pronouncements day in and day out about laissez-faire capitalism and allowing the marketplace to work. I am beginning to believe that most us do not really believe that, particularly as we pursue these hearings.

Let me just share with you what my agitation is about. A recent *Wall Street Journal* headline read, and I quote: "Rates on Mort-

gages Behaving Strangely, Fail to Come Down." And the story is quite simple. Wall Street experts say that based on historical market conditions, interest rates in the past weeks, and I quote: "should be significantly below 8 percent," but according to the *Wall Street Journal*: "Again, the threat of legislation or some other governmental action in turn, has helped keep prices of mortgage-backed securities lower and yields higher."

So I suppose what we have is one of the most respected financial publications in America confirming that the mere threat of this bill that is the subject of this hearing is keeping interest rates higher than they should be. In other words, the bill, Mr. Chairman, that you proposed, is already raising costs for American homeowners and keeping potential homeowners out of business.

Chairman BAKER. Would the gentlewoman yield briefly on that point? I will give you an extra 30 seconds, so I am not chewing up your time.

I think if we were to read the whole article, in its entirety, the reason cited for the inability of rates to drop was the repurchase of debt by the Treasury Department, not the committee hearing process. And I think that that document stated that.

I thank the gentlewoman for yielding.

Ms. WATERS. Certainly, Mr. Chairman, but let me say that I have talked now with any number of people who are worried that precisely what was described in the *Wall Street Journal* article is true.

Now, let me just continue. Fannie Mae and Freddie Mac are two of the strongest companies in the country. Fannie Mae ranks 26th and Freddie Mac 62nd on the Fortune 500 list of top American companies. Currently, Fannie Mae holds more than $19 billion in capital. In its 1999 report to Congress, the Office of Federal Housing Enterprise Oversight, the congressionally appointed safety and soundness regulator for Fannie Mae and Freddie Mac, found both Enterprises to be financially sound and well managed. OFHEO also stated that Fannie Mae exceeds safety and soundness standards in every category.

In 1997, at the request of OFHEO, the rating agency Standard & Poor's evaluated Fannie Mae and assigned them an AA rating in terms of their risk to the Government, a rating only a handful of institutions meet. Additionally, in July 1999, *Fortune Magazine* named Fannie Mae the second-best company for employment in the country for Asian Americans, African Americans and Hispanic Americans.

Fannie Mae and Freddie Mac are Government Sponsored Enterprises, as we know. They are congressionally chartered, but shareholder-owned corporations. They enjoy federally granted benefits in support of their important public purpose which is to increase nationwide access to residential mortgages by developing and supporting a secondary mortgage market for housing finance. Fannie and Freddie pass their federally granted value on to mortgage borrowers in the form of lower interest rates.

According to a June article in *Money Magazine*——

Chairman BAKER. I hate to ask you, but can you begin to wrap up?

Ms. WATERS. Unanimous consent for 60 seconds.

Chairman BAKER. Without objection, certainly.

Ms. WATERS. According to a June article in *Money Magazine*, American soaring home ownership rates and the reduction in down payment requirements are evidence of Fannie's and Freddie's benefits to American consumers. Similarly, in a 1996 Congressional Research Service report, stated that comparison of mortgage rates in conforming and non-conforming markets have led analysts to conclude that the presence of the GSEs has lowered mortgage rates between 25 and 50 basis points. Lower mortgage rates result in thousands of dollars saved for American consumers.

I cannot complete my statement, I don't have enough time, but I guess the question I am raising is, what is broken and what are we trying to fix? Why have we taken the argument of FM Watch, a group of subprime lenders who simply do not want to compete with Fannie and Freddie, and simply are concerned that they are going to bring new products for our consumers that will lower the cost of mortgages?

I do not like being in the middle of this fight. I do not think it is fair, Mr. Chairman; and I just must put that on the record.

Chairman BAKER. Thank you, Ms. Waters.

Mrs. Roukema.

Mrs. ROUKEMA. Thank you, Mr. Chairman. I do want to commend you. Despite what the previous speaker, our colleague, said, I do want to commend you for this hearing. This is the second hearing, I believe, on this very important issue. I believe that it is important to all of us, and certainly all the homeowners that are out there. After all, what we are discussing is the "American Dream," and we are not going to abandon that.

But I would like to make the point, Mr. Chairman, that we are not going to take precipitous action on your bill. I think you have confirmed to Members of the committee that you will move very slowly. It is a highly complex subject. I, for one, as well as others who have already spoken on this, have said that we have to examine it thoroughly and understand all the consequences; and it is absolutely essential that we understand the complexity of this and not take precipitous action.

So I am very pleased to hear what you said in your opening statement, Mr. Chairman. However, there are other issues that have already been outlined, but that I did not hear; and I want to stress—even if it has already been said, I do want to stress to the GSEs who are here today about the question of mission creep. As a general rule, they are not supposed to be competing with the private sector, except where explicitly authorized by Congress. I know there are real concerns about Freddie and Fannie expanding their lines of business. Just to state a couple of instances, some are suggesting that they are getting into real estate brokerage, consumer lending, mortgage insurance, and other areas which arguably are not part of their mission. I hope we could address those questions today, because they are central to the debate and review we are doing here.

At the same time, I want to acknowledge that there is a potential liability to taxpayers if their actions are not well managed on the other side of the question.

So I am very pleased to be here today and to carry on as part of our obligation here in subcommittee to fully explore the pros and cons of this essential issue about how we assist homeowners in a safe and sound manner through the proper capital standards.

Thank you, Mr. Chairman.

[The prepared statement of Hon. Marge Roukema can be found on page 210 in the appendix.]

Chairman BAKER. Thank you, very much Mrs. Roukema for your participation and your leadership on this and other issues.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

First of all, Mr. Chairman, even though you and I do not always agree, or we agree on some things and not others in the same legislation, I want to commend you for holding these hearings. I think—while I have some problems with your legislation—I think you have been thoughtful in the process. I would encourage my colleagues not to make up your minds quickly on this legislation. I think we need to look at the facts.

First of all, we also have to remember that Fannie Mae and Freddie Mac and the Federal Home Loan Bank system are not something that came about on their own. This is something that Congress created over time. We established the laws, we have had charter reviews, and now there are some who are saying what we have done may have been a mistake, or we have allowed the monster to grow too big. So let's be cautious in our approach.

Second of all, I would say that I thought the previous hearing, and particularly the comments from the Under Secretary Gensler, were really quite stunning. And I would concur with Ms. Waters that it did create a market reaction, because regardless of how much disclosure Fannie or Freddie put on their documents with respect to Government guarantee, I strongly believe—and I had the opportunity to work both with and against Fannie Mae in the mortgage markets before coming to Congress—but, I strongly believe that the capital markets believe that there is some implicit guarantee on the part of the Federal Government.

Now, I know that both these gentlemen will tell us today that there is none, that they are adamant about it, and they are being correct in their statements, but the market believes otherwise. And as such, I think we should consider that going forward.

We cannot, on the one hand, or we should not on the one hand be taking something away that affects the value of these companies which have done a pretty good job, quite frankly, for the mortgage market, and at the same time be reigning them in. We will have to make a choice. If we choose to do anything at all, we will have to make a choice of either going one direction or the other, but you can't go both ways. And, unfortunately, I think the way the bill is currently drafted, it goes both ways.

And with that, I do commend the Chairman, my colleague from Louisiana, and I appreciate him holding these hearings.

Chairman BAKER. Thank you very much, Mr. Bentsen. I appreciate your remarks.

Mr. Toomey, do you choose to make a statement?

Mr. TOOMEY. Thank you, Mr. Chairman.

Very briefly, I would just make the observation. I don't believe there is any question the market believes there is an implicit guarantee of the debt of the Government Sponsored Enterprises. And as such, I am reluctant to conclude that the market is completely wrong when it is virtually unanimous in its conclusion. I would believe that a guarantee has inherent value, and if there is inherent value in such a guarantee, then it seems to me that the value should be compensated; and the form of the compensation presumably is the value of improving access to home mortgages. But there is a cost to that, and the cost is this cost of the implied guarantee, and I think it is important to evaluate whether there is a proper return for that cost.

And so it is very useful to have this hearing today, I think, and I thank the Chairman for pursuing this so that we have an opportunity to discuss the various activities, how those activities relate to the profitability of the firms, but also how they relate to the mission of the Enterprises. Because it goes to the question of whether or not the cost borne by the taxpayer is properly being compensated.

So I want to thank the Chairman for conducting these hearings, and I look forward to the testimony of the witnesses. Thank you.

Chairman BAKER. Thank you Mr. Toomey.

Does any other Member desire to make an opening statement? Let me get my list here. Mr. Terry is next by time of arrival, then Mrs. Biggert, and then Mr. Cook.

Mr. Terry.

OK, Mrs. Biggert.

Mrs. BIGGERT. Thank you, Mr. Chairman. I first want to commend you for holding another hearing on this very important issue.

The Government Sponsored Enterprises have helped make the American dream of owning a home a reality for hundreds of thousands of families throughout the country. For example, the Home Loan Bank of Chicago has invested over $32 million in housing loans in my district, while Fannie Mae has provided mortgages for some 60,000 families in the Illinois 13th Congressional District alone.

Despite this good work, I do have some concerns about the GSEs' large debt obligation, and wonder whether legislation may be necessary to protect taxpayers from another bailout crisis, should an economic downturn occur. On the other hand, I am not sure that the regulatory process contemplated in H.R. 3703 would allow the innovation that the GSEs will need to be able to adapt easily to the changing mortgage market of the future.

So, therefore, Mr. Chairman, I look forward to the testimony of the panelists and anticipate a very spirited and educational question-and-answer period. Thank you.

Chairman BAKER. Does any Member on the Democratic side choose to make an opening statement?

If not, Dr. Paul you are next and then you, Mr. Cook.

Dr. PAUL. Thank you, Mr. Chairman. I want to thank you for holding these hearings.

These are certainly very important. This problem has been around for a good while. There are some in the financial media that have been talking about this for a long time, talking about a

ticking time bomb. There are some others who think it might be a little too late to do much about it. But the implicit guarantee is obviously something that needs to be discussed and dealt with.

I am interested, though, in a little bit more than just the apparent debt that the GSEs have accumulated, but the relationship of this accumulation of debt through monetary policy.

For the GSEs to go out and borrow these huge sums of money, into the trillions, it could not be done without pushing up interest rates, without a generous Federal Reserve policy of keeping interest rates low, because when you subsidize something, you get more of it.

And, of course, it has been beneficial to the housing industry; we have had good times in housing. But it is also the substance of which bubbles are made. So there should be a concern about this. This huge obligation that we have will be met. I think it will be very difficult for us to walk away from it. I think it is implicit that something will be done if trouble hits, and that is bothersome to me.

But it is also bothersome to me in the monetary policy sense that since last fall our Federal Reserve has decided not only to make credit generously available for the GSEs to borrow, they are literally monetizing this. They are buying up GSE papers and holding them as an asset which they can use as a collateral against Federal Reserve notes. And not only that, there has been an increase in foreign central banks' holding of this GSE paper as well.

So, first, we create a lot of credit to make these loans available, and then we literally turn around and buy them back at the Federal Reserve level, which has monetized them. So this is a huge bubble that we have built. And at the same time, we allow our banks to borrow these without any reserves set aside, which enhances their ability to increase their credit within the fractional reserve banking system.

That is the area that I have concern about, and I hope to address that in the question-and-answer session.

Thank you.

Chairman BAKER. Thank you, Dr. Paul.

Any Member on the Democrat side?

If not, Mr. Cook.

Mr. COOK. Thank you, Mr. Chairman. I would just like to make note that America's home ownership rate is at an all-time high of 68 percent. While the hard-working American public deserves the lion's share of credit for this, I would like to express my appreciation to the witnesses scheduled to appear today for the supporting role they have played in making all of this possible. The institutions they represent certainly have all played critical roles in the home ownership process and have all helped to make America's housing finance system the envy of the world.

Mr. Chairman, I have no problem discussing the regulatory issues affecting Government Sponsored Enterprises. The manner in which GSEs are regulated is clearly within the purview and jurisdiction of this subcommittee. And I want to express my hope that we can carefully analyze the impacts that this legislation will have on the entire housing finance industry and the capital markets.

But I am very troubled and not sure of the intent of having GSEs publish the details of each new mortgage product they seek to produce in the Federal Register for public comment. I am not sure how hampering their ability to innovate would make a difference for homeowners.

Fannie Mae has opened a Utah partnership office in my district for the purpose of offering flexible and innovative mortgage products which lenders can offer on a neighborhood-to-neighborhood-basis. I think clearing those new products through the layers of HUD bureaucracy in Washington is concerning to me.

We are well aware of how inefficient HUD can be at times, and with this in mind, it should give us cause for concern. With a healthy economy, high mortgage loan demand, and the current good management of the housing GSEs that are in sound operating condition, now is a good time to examine these entities and their position in our current financial system; and I commend you, Mr. Chairman, for holding this hearing to discuss the role of GSEs.

I will have a number of questions about the scope and intent of H.R. 3703, and I look forward to hearing the views of the witnesses on how consumers stand to benefit from this legislation.

Chairman BAKER. Thank you, Mr. Cook. If no further Members desire to give an opening statement, I would proceed to our witnesses.

I would like to first call on the CEO of Fannie Mae, Mr. Franklin Raines, who of course was the former Director of OMB in the Clinton Administration, a very accomplished individual.

And let me assure you, Mr. Raines, that all my comments and discussions concerning future issues with regard to Fannie are in no way intended to reflect on your management or your competency in your role as the chief operating officer. In fact, my concerns are aimed some years down the road—when there is no longer a Franklin Raines; and I would bet some would say, "I hope that is when Baker is not in Congress too"—that there might be problem on the horizon that neither one of us would choose to see, nor can we forecast.

But inevitably, business cycles are that. So it is with that perspective of containing systemic risk that I have made my remarks and proposed H.R. 3703; and I have appreciated your willingness to come by the office and talk about the issue. I look forward to working with you.

We would be pleased to hear your testimony.

STATEMENT OF FRANKLIN D. RAINES, CHAIRMAN AND CEO, FANNIE MAE

Mr. RAINES. Thank you very much Mr. Chairman. Thank you for that kind introduction. And let me also thank the Members of the subcommittee for this opportunity to meet with you here today.

I have submitted extensive written testimony which I would ask be included in the record.

Chairman BAKER. Our witnesses' testimony is included in part of the official record, without objection.

Mr. RAINES. So I will just summarize that more lengthy testimony in my oral statement.

Before I begin, let me——

Chairman BAKER. I am sorry, Mr. Raines, I apologize. I meant to say, I said it long ago, but to the extent possible, can your testimony be under ten minutes, as a goal?

Mr. RAINES. Yes, I will try to make it as quick as possible. I will shoot for that as a goal.

Let me say that the housing finance system today is very strong. It is vibrant, it is safe and sound, and it serves consumers better than ever. And this is due in no small part to the careful scrutiny, sound judgment and constructive action that Congress has taken over many years.

The outcome of Congress' long-standing commitment to home ownership is that millions of families have achieved the American dream. The benefits of the astounding growth of home ownership have rippled out to improve the wealth of average families, the health of communities and the strength of the U.S. economy. We all want to keep this success going, so it is entirely appropriate for Congress to have oversight hearings on the safety and soundness of the secondary mortgage market today, and Fannie Mae welcomes this oversight.

I am pleased to be here, Mr. Chairman, because there is a good story that deserves to be told. The U.S. housing finance system is the best in the world, the most efficient and effective ever devised. The American Dream of home ownership is more alive and achievable and inclusive than ever. The national home ownership rate has just set a new record of over 67 percent. The housing market is robust. The housing industry is strong, and for consumers, it has never been easier or more possible to buy a home.

Behind this success story is the secondary mortgage market. What this market does is to attract billions of dollars of private capital from all over the world to provide mortgage lenders with a steady flow of funds to lend to all communities, under all economic conditions, at the lowest rates in the market with zero risk to the Government. The secondary market ensures that a home buyer will never hear her lender say, "I'm sorry, we are out of money to lend."

Keeping the supply of mortgage funds up also keeps the cost of mortgage funds down, which means more families can afford to qualify for a home loan.

The secondary market also makes consumer-friendly mortgages possible. In America, we take the long-term, fixed-rate mortgage for granted, with down payments as low as 5 and 3 percent. Last year, 66 percent of all conforming mortgages originated in the United States were thirty-year fixed-rate loans. Outside our country, this kind of mortgage is a rarity.

In Canada, they have the rollover mortgage where the rate is fixed during the first one to five years with a prepayment penalty equal to three months of interest. The fixed term in Spain is usually one year. In France, 80 percent of all mortgages have variable rates. In Germany, you can get a fixed rate for five to fifteen years, but you cannot refinance during this period without paying a huge penalty. And in Germany, the down payment is typically 30 to 40 percent. In Japan, you have to put down effectively 50 to 60 percent in order to buy a home.

There is a simple reason why the low down payment, long-term, fixed-rate mortgage is so common here and uncommon elsewhere.

Most countries do not have a secondary market to buy or guarantee loans that lenders originate, so the lender requires the consumer to pay more up front and more each month if mortgage interest rates rise. Overseas, the U.S. secondary mortgage market is considered some kind of miracle.

Fannie Mae is proud of that, but we know where the credit belongs. It was Congress that created the secondary mortgage market. It was Congress that chartered Fannie Mae and later Freddie Mac as private shareholder-owned corporations, so Congress deserves the lion's share of the credit for the successes of the secondary market and the housing finance system today.

What Congress did turned out to be absolutely brilliant. It created a system that harnesses private enterprise and private capital to deliver the public benefit of home ownership. And it maximizes this public benefit while minimizing the public risk, and without spending a nickel of public funds.

Then in 1992, Congress improved on its work. After the thrift and banking crises and reforms, Congress wanted to make sure that Fannie Mae and Freddie Mac were fulfilling their housing mission in a way that was financially safe and sound. After two years of hearings, several Government studies and much discussion, Congress passed a 140-page bill called the Federal Housing Enterprises Financial Safety and Soundness Act of 1992. In effect, Congress strengthened both sides of our equation. The 1992 Act increased the public benefit we provide, and it decreased the possibility of public risk even more.

Let's look at increased public benefit. The 1992 Act gave Fannie Mae and Freddie Mac the toughest affordable housing goals in the financial services industry. Under our housing goals set by HUD, we have to meet specific percentage of business goals. For example, starting next year, we have to devote at least 50 percent of our business to families living at or below their area median income. That is up from 30 percent when the law took effect in 1993.

But Fannie Mae has always viewed our HUD goals within our own more dramatic goals. In 1994, Fannie Mae pledged to provide $1 trillion of financing to 10 million underserved families by the end of the year 2000. We met that goal last month, and immediately pledged to provide $2 trillion to 18 million families before this decade is over. We call this new pledge our "American Dream Commitment."

These efforts have transformed Fannie Mae. We exceed our HUD goals every year. We have increased our lending to low-income families by 28 percent, to African American families by 31 percent, and to minorities as a whole by 16 percent. Last year, we provided $46 billion in financing to over 400,000 minority families.

Fannie Mae is now the Nation's largest affordable housing company. We lead or match the primary market in serving low-income or minority families even though we do not originate a single mortgage. We rely on lenders to originate the loans, so we help lenders reach these consumers and get them approved.

Reaching these new markets, if not done right, could be more risky. But Congress in 1992 gave us a new structure to reduce our risk. First, Congress gave us our own specialized safety and soundness regulator, the Office of Federal Housing Enterprise Oversight,

known as OFHEO. OFHEO conducts regular on-site safety and soundness exams. They have an office in our building and a lot of regulators on the job. OFHEO has 26 examiners for two companies—a 13-to-1 ratio. In comparison, the FDIC has one-third of one examiner for each bank that it regulates. And our financial regulator is the only one that discloses the results of our exams to the public.

In our most recent exam, it reported and I quote: "In all categories, Fannie Mae exceeds safety and soundness standards." These safety and soundness standards, also found in the 1992 Act, are the most rigorous in the financial services industry. Unlike the simple leverage standard that banks use, where they hold a ratio of capital to assets, Fannie Mae and Freddie Mac have a risk-based capital standard with a stress test. It requires us to hold enough capital to actually survive a worst-case scenario. Now, let me explain, because this test is unusual.

The stress test assumes that interest rates either rise or fall by up to 600 basis points and stay there for ten years. Then it takes the worst credit losses that the United States has suffered in the past twenty years in residential mortgages, which was a portion of the oil patch in the 1980's, and then this devastating scenario is applied nationwide and assumed to go on for ten years.

But we are still not done. We then have to add 30 percent of capital for management risk. So we must hold 130 percent of the capital necessary to survive this ten-year test.

Now, how tough is this standard? According to one study, if the devastating stress-test scenario in our capital requirements ever came to pass, thrifts would deplete their capital base in five to seven years and become insolvent. By year ten, Fannie Mae and Freddie Mac might be the only major holders of mortgage assets in America still standing. Fannie Mae's charter confers certain benefits that help us meet our Federal requirements to be in all markets under all conditions. But also Federal bank charters confer certain benefits to banks such as access to the Fed window, and direct, not implied, Government backing through the Federal guarantee of deposits.

We can also measure how Fannie Mae passes its benefits to consumers every day. All you have to do is look in the Saturday *Washington Post*, in the real estate section, at the mortgage rate charts and compare the left column, the conventional conforming rate, with the right column, the jumbo rate. The left column is the mortgages that we back, which are always cheaper than the column on the right.

Right now, a Fannie Mae-backed mortgage is about $19,000 cheaper over the term than a jumbo loan that is $1 over our loan limit. And we also have a loan for borrowers with slightly impaired credit that is about $20,000 cheaper than the loan they might get in the subprime market. And what is even more surprising is that a Fannie Mae-backed mortgage is even about $21,000 cheaper than a Government-backed FHA or VA loan.

During the 1990's, we estimate that we directly saved consumers at least $20 billion by lowering mortgage rates, and that is counting the market impact we have on jumbo and other loans bought by others by driving down conventional rates. The way Fannie Mae

is regulated and the business that we are in makes our company uniquely safe and sound.

Chairman BAKER. Can you begin to wrap up, Mr. Raines?

Mr. RAINES. I will, Mr. Chairman.

Our asset, the mortgage, is one of the safest. We only invest in one type of asset, mortgages. We do not buy commercial real estate. We do not buy junk bonds. We do not buy Danish bonds. Just one homely asset. And we have one job and that is to manage risk. Last year, we paid out one-half of our gross revenue, $6.4 billion, to manage risk. And it is worth it.

During the thrift crisis, we kept our credit losses at 5 basis points, 5 cents for every hundred dollars, while banks paid out 86 cents for every hundred dollars. And right now our losses are as low as 1 basis point, one cent for every hundred dollars.

Over the last twenty years, there have been financial difficulties for fifteen industries, the mortgage insurance industry, the banking industry, the thrift industry. The savings and loan industry cost $125 billion. The banking industry cost their insurance fund $36 billion. Fannie Mae suffered losses in the 1980's, though it never became insolvent. It righted itself without costing the Government one penny.

Mr. Chairman, let me summarize by saying just a couple of words about the subcommittee's actions with regards to the proposed legislation. The question before the subcommittee is whether the 1992 Act should be modified. And we welcome this question. As I said, congressional oversight has helped to create the strong system we have today. But as for the legislation that has been proposed, we have submitted in our written statement a section-by-section analysis, and we would be delighted to answer any questions about that analysis. In our view, however, there is no part of the bill, as proposed, that improves the system or improves upon what Congress achieved in the 1992 Act.

Let me emphasize that our concern is not with congressional oversight, the hearings of this subcommittee or proposals to improve the housing finance system. Our concern is with any actual change in the law that would weaken our charter or impose regulatory burdens that would raise our costs of providing capital to the housing finance system.

Thank you, Mr. Chairman and Members of the subcommittee. I look forward to discussing these issues with all of you.

[The prepared statement of Franklin D. Raines can be found on page 214 in the appendix.]

Chairman BAKER. Thank you, Mr. Raines.

The next witness is the Chairman and Chief Executive Officer of Freddie Mac, Mr. Leland Brendsel.

And let me say for the record, Mr. Brendsel, over the past weeks I have been working with some of your senior management folks, getting concrete suggestions for modifications that possibly could lead us to legislation that the organization may not strenuously object to, and I just—whether the outcome of that is productive or not, I simply want to say thank you for those efforts.

And we welcome your remarks.

STATEMENT OF LELAND C. BRENDSEL, CHAIRMAN AND CEO, FREDDIE MAC

Mr. BRENDSEL. Thank you, Mr. Chairman. And good morning, Congressman Kanjorski, Members of the subcommittee. Thank you for inviting me to be here today. I welcome the opportunity to talk to you about Freddie Mac and the tremendous benefits and the work that we have done and we are doing for America's families, home buyers and renters.

Congress created Freddie Mac in 1970 with a special purpose and a vital role. And I think that the dramatic improvements for home buyers since then is a great success story and a great testament to that vision for Freddie Mac in 1970.

I believe our ability to continue meeting our mission rests on maintaining the confidence of the markets and of the Members of this subcommittee and the United States Congress. And I certainly want to work with this subcommittee on achieve this objective.

Freddie Mac's role is, and always has been, to link families in the Nation's communities with the global capital markets. The mortgages we buy are mortgages on people's homes, and obviously they are high-quality, low-risk assets, because they are backed by people's homes. And the securities we issue attract investors worldwide to finance America's housing.

For thirty years, Freddie Mac has been at the forefront of innovation. From the standardization of mortgage documents, now accepted, which occurred in the 1970's, to the development of automated underwriting systems, new technology of the 1990's, we have reduced the time, we have reduced the costs, and we have increased the availability of mortgage loans.

Freddie Mac's single-handed creation of the market for conventional mortgage securities back in the 1970's and the development of a global investor base for our debt securities today is further reducing mortgage costs and expanding housing opportunities.

Freddie Mac has opened doors to home ownership and housing for low-income families and for minority families. In fact, we have now financed homes for more than 25 million families in America since our beginning. The result, as already said, is the Nation's highest home ownership rate ever, and a housing finance system, as said by Chairman Raines, that is the envy of the world. And by any measure, our success is evident, whether you look back in history or you look at parts of the market we do not serve today, or you look at other countries. Any way you look at it, the market we serve does a far better job for home buyers than the market we do not.

Now, I think it is appropriate for Congress and for this subcommittee to examine Freddie Mac and Fannie Mae and the Federal Home Loan Bank systems, and to ensure that future generations of home buyers, as well, enjoy these benefits. Indeed, over the next decade, America's families will need another $6 trillion to finance their homes, including more than $2 trillion for first-time home buyers.

Some of Freddie Mac's competitors think this can be accomplished without a vibrant, without a growing secondary market. They bear the burden of proof, I think, that uprooting this tremendous housing finance system would benefit America's home buyers

and renters. But there is no way that they can meet this standard, so instead, they distort the record.

I would like—in my brief minutes that remain, I would like to set the record straight on three points. First, it has been suggested that Freddie Mac can continue to meet our public mission without issuing debt securities. The reality is that debt financing is essential to meeting our mission and is becoming even more important as the number of new home owners grows. Our use of both mortgage-backed and debt securities has enabled us to build a diverse investor base, first, within the United States and now internationally. The benefit is lower costs for home buyers and tremendous stability for the mortgage market.

Indeed, the fall of 1998, most recently, is a prime example, when capital markets were in turmoil, but the mortgage market that Freddie Mac and Fannie Mae serve worked flawlessly. There was no disruption whatsoever.

And by funding mortgage purchases with both our mortgage-backed and debt securities, we save millions of dollars in interest, and American families can count on the availability of mortgage credit whenever and wherever they need it.

Now, the second distortion is that we represent another thrift crisis in the making. The reality is that Freddie Mac and Fannie Mae are specialists in the management of the risk of making or purchasing and funding home mortgage loans. And Freddie Mac is one of the strongest financial institutions in the country. We pioneered the development of automated tools that enable us to accurately assess mortgage credit risk and help families avoid foreclosures. We pioneered the development of mortgage securities, callable debt and the use of other financial instruments that enable us to match the maturities of our assets and liabilities.

Not only is Freddie Mac highly skilled at managing risk, we are extremely well capitalized for the risk we take. We hold enough capital to withstand ten years of severe adverse economic conditions, much like the Great Depression. The difference between Freddie Mac and the thrift industry could not be more stark. As you know, thrifts in the 1980's were funding long-term mortgages with short-term deposits and then took on more and other kinds of credit risks. And even today, the thrift industry is nowhere near the capital strength of Freddie Mac. We commissioned a recent study by industry experts that calculated that the thrift industry would have to triple its capital to meet our risk-based capital standard as proposed.

Now, we also asked another expert, one probably well known to you, Bill Seidman, former Chairman of the FDIC. We asked him to review our risk-based capital standard, and he concluded that if it were applied to other financial institutions, it would be, and I quote: "devastatingly stringent." I ask that both reports be placed in the record of this hearing. Thank you.

Chairman BAKER. Without objection.

[The information can be found on page 294 in the appendix.]

Mr. BRENDSEL. The fact is, if thrifts held as much capital relative to risk as Freddie Mac does, there would never have been a thrift crisis.

The third distortion about Freddie Mac is that we engage in activities that are beyond our charter. What are we accused of? We are accused of using the latest technology to reduce the time and cost of getting a mortgage loan made by lenders, our customers. We are accused of responding to lenders who want to sell mortgages over the internet. And we are accused of trying to improve the practices in the subprime sector.

All these activities make mortgages more affordable, streamline the mortgage process, and open doors to home ownership, and all these activities are squarely within our charter, support our public purpose, and have tangible benefits to consumers, home buyers and renters.

Finally, I would like to say a few words about your desire to ensure a strong, independent and effective safety and soundness regulation for Freddie Mac. We share this objective, but we do not think H.R. 3703, as introduced, is the way to achieve it.

So let me again express my desire for the Congress to have confidence that Freddie Mac is meeting our very important mission in a safe and sound manner. Again, we would be happy to work with you to achieve this important objective. We are committed to making the world's best housing finance system even better for America's families.

Again, thank you for the opportunity to appear today, and I welcome any questions that the subcommittee may have.

[The prepared statement of Leland C. Brendsel can be found on page 266 in the appendix.]

Chairman BAKER. Thank you, Mr. Brendsel, for your remarks and for your willingness to work with us in the days ahead.

Our last witness is the Chairman of the Council of Federal Home Loan Banks, Mr. Curtis Hage.

Welcome. It is a pleasure to have you with us.

STATEMENT OF CURTIS L. HAGE, CHAIRMAN, COUNCIL OF FEDERAL HOME LOAN BANKS

Mr. HAGE. Good morning, Chairman Baker, Congressman Kanjorski and Members of the subcommittee. My name is Curtis Hage; my bank is Home Federal Savings Bank of Sioux Falls, South Dakota. It is one of the 7,400 owner banks in the Federal Home Loan Bank system.

For disclosure purposes, I should mention that I wear several hats. I am a member of the board of directors of the Federal Home Loan Bank of Des Moines. I am the Second Vice Chair of America's Community Bankers, and I currently serve as Chair of the Council of Federal Home Loan Banks. I am here today on behalf of the Council.

I am here to tell you that partnership with the Federal Home Loan Bank of Des Moines is very important to our bank's success. Moreover, our success is important to the twenty communities, small and large, that we serve in South Dakota.

Mr. Chairman, and Congressman Kanjorski, I would like to take this opportunity to thank you both for the extraordinary efforts you put forth to enact legislation to modernize the Federal Home Loan Bank system. Without your leadership and efforts, the Federal

Home Loan Bank System Modernization Act of 1999 would not have come to fruition. This is an important Act.

First, the legislation decentralized management of the Federal Home Loan Banks, local governance decisions are most effective if made at the local level;

Second, leveling the playing field of membership status was an important and appreciated change;

Third, the addition of small business and farm loans as eligible collateral for smaller community financial institutions provides needed access to more funding; and

Finally, thanks to this legislation, the capital structure of the Federal Home Loan Bank system is being revised for the first time in sixty-eight years. This is an extremely important and dramatic revision. If carefully crafted with coordination and support from the Federal Home Loan Bank members, it can improve an already strong system.

Again, Mr. Chairman, we want to emphasize how constructive you were in the legislative process over the last several years, and we know that your intentions with H.R. 3703 are constructive as well.

Your staff has remained in communication with our offices relative to our issues of concern. In fact, modifications suggested by your staff would significantly alter our areas of concern. If such modifications are adopted, I believe the Council of Federal Home Loan Banks would not have objection to favorable consideration of H.R. 3703. With that as the context, I would like to make three key points this morning and ask the subcommittee to reference my written testimony on the specifics of H.R. 3703.

The first point is that the Federal Home Loan Bank system is unique. It is a child of the Depression, designed to partner with local financial institutions starved for liquidity and, thus, unable to lend. The Federal Home Loan Banks' liquidity mandate is no less important today than it was seventy years ago. But now, in addition to being vital tools for housing finance liquidity, they are also vital community lending and development tools. In fact, Federal Home Loan Banks, through their members, build communities.

Because of this important function, and because our members' funding needs are growing, the Federal Home Loan Banks are growing. The 1990's saw the mutual fund industry explode to over $7 trillion. A great deal of that growth came from deposits in local banks.

In spite of this massive deposit drain, banks and thrifts continue to provide credit to their communities through the advances provided by the Federal Home Loan Banks. This dependable, low-cost source of funds supports the continued lending role of community banks.

We note with great concern that after the last hearing you held on this subject, the rate spreads on GSE debt jumped substantially and our fund costs increased. Clearly, the Treasury line of credit needs to be handled cautiously.

A second key point is that the Federal Home Loan Banks operate in a very safe and sound manner. We are subject to annual safety and soundness exams. We have, by regulation and practice, an extremely low tolerance for credit- and interest-rate risk. In fact, the

system has never experienced a credit loss. Two reasons for that great track record are that the Federal Home Loan Bank advances are fully collateralized and we have statutory lien protections for that collateral.

H.R. 3703 proposes removing this protection in Section 138. In our view, that removal would be problematic and serve no purpose.

Current law requires the Federal Home Loan Banks to secure their loans with specified collateral. Rather than identifying, assigning, or perfecting that collateral, which would be a costly and time-consuming process, well-capitalized community banks and other portfolio lenders may use a blanket lien to cover their entire portfolio of eligible collateral. This is a practical and efficient way to hold down the costs of advances and the administrative burdens for the community bank, the consumer, and the Federal Home Loan Bank.

Furthermore, in the event of a loss by a financial institution, the super lien, like a perfected lien, would have first claim on the failed bank's assets. Removing the super lien would not, as some purport, place the Federal Deposit Insurance Corporation in a better position in the event of a bank failure. Without the super lien, the Federal Home Loan Banks would perfect their security interests and, thus, have a first claim on the assets.

Finally, the third point I wanted to make today, is that the biggest job facing the Federal Home Loan Bank system is the daunting task of capital restructuring. The sweeping capital changes brought by the Modernization Act require Federal Home Loan Banks to prepare and implement a new capital structure. Many complex issues and decisions need to be made and broadly understood to create a sound, new, permanent capital structure.

Therefore, with all due respect, changing the regulator of the Federal Home Loan Bank at this time would be most problematic. We are also concerned about the limitations Section 111 of H.R. 3703 would impose. We prefer assurances that limitations would not be arbitrary or counter to good, safe and sound balance sheet management. The Federal Home Loan Banks' loss-free record is due in great part to the flexibility that management has had historically to manage their balance sheets in difficult times.

The housing finance market is cyclical, which means our advance business is also cyclical. Mortgage-backed securities are a financial management tool that is a low-risk and readily tradable commodity used by our members every day. The finance board currently limits our purchase of MBSs to three times capital. We believe that limitation is sufficient to focus the Federal Home Loan Banks on their mission.

We believe that the legislation should respect the need for flexibility, allowing MBS as a mission-consistent tool to ensure safe and sound business management. Without a safe and sound balance sheet, no advances will be made, no affordable housing grants will be made and no members will join the system.

As we restructure our capital to provide for a strong and flexible home loan bank system, we envision a capital structure that will allow the banks to meet the lending needs of the communities and customers that we serve.

Mr. Chairman, this concludes my statement, and I would be happy to address any questions the subcommittee may have.

[The prepared statement of Curtis L. Hage can be found on page 323 in the appendix.]

Chairman BAKER. Thank you very much Mr. Hage. And I do appreciate the staff's willingness to converse with us on substantive modifications to the proposal that might wind up in a legislative approach which you would find acceptable, and I do appreciate that very much.

Mr. Raines, it has been stated here several times already this morning, but would you confirm the view that the securities issued by Fannie Mae are not backed by the full faith and credit? This is stamped on the face of the security; is that correct?

Mr. RAINES. It's stamped on the face of all of our offering documents, as required by law, that they are not backed by the full faith and credit of the United States and they are solely the obligations of Fannie Mae.

Chairman BAKER. And if down a distant road you are no longer CEO and I am not in Congress, circumstances develop where we have a soft housing market, interest rates have skewed up, difficult circumstances, let's say as in the 1980's, net worth insolvency is imminent, in the workout of that difficulty, would you expect investors of securities to take a haircut in the workout before you get to the taxpayer?

Mr. RAINES. Well, Mr. Chairman, the circumstances in which Fannie Mae would reach any kind of insolvency are such that the country would be in a devastated condition. All the thrift industry would be gone. The banking industry would be gone, and so we are talking about a very extraordinary circumstance.

Chairman BAKER. Sure.

Mr. RAINES. But what I can say is, as you know, if that were to occur, we would expect that our regulator would implement the provisions that are included in the 1992 Act. The 1992 Act provides the procedures by which, if Fannie Mae were to have impaired capital, the regulator would step in and begin to take actions, including putting the company into conservatorship. And given the liquidity of our assets, we would expect that we would see an orderly elimination of the problem as our assets were sold off, given their great liquidity. One of the big differences between Fannie Mae and Freddie Mac and a thrift or a bank is that we invest in highly liquid assets that are easily sold into the marketplace. So as long as liquidity in the general marketplace exists, then Fannie Mae would be able to adjust its book position to whatever capital it had.

But I want to stress, it would take very devastating circumstances for that to occur. And that is exactly what our capital standard does; it says you must be protected even if these devastating circumstances occur.

Chairman BAKER. Sure. But the question was, would investors be required to take a haircut in such insurmountable, unlikely, impossible circumstances? Would that be the logical order before we get to the taxpayer in trying to understand what is the implicit guarantee worth and when do we get to the taxpayer's pocketbook?

Mr. RAINES. Well, Mr. Chairman, I don't believe you ever get to the taxpayer's pocketbook. I believe our current regulatory struc-

ture and capital structure protects taxpayers in all conceivable events. Our investors are protected by the assets that we have. They are protected by the extraordinary equity in American homes. They are protected by the billions of dollars of mortgage insurance that we have purchased. And then they are protected by our capital.

Chairman BAKER. I do not dispute that today. But this is going back to 1979-1983 kind of conditions, when it did happen. There was an insolvency technically, and forbearance of the Congress did enable a workout to occur.

Mr. RAINES. There was never an insolvency of Fannie Mae. Fannie Mae has never been insolvent. Not once.

Fannie Mae suffered losses in the early 1980's. They were significant losses. Fannie Mae righted itself without any assistance from the Federal Government. Fannie Mae was able to modify its business activities and to right itself.

But the 1992 Act is what ensures that the early 1980's won't occur, because our capitalization is so much higher.

Chairman BAKER. I am going to stick to the five-minute rule and try to apply it to myself as well.

Since Fannie Mae is so well capitalized, so well managed and so profitable, wouldn't the repeal of the line of credit be purely symbolic and that is all? It does not equal one week's trading. Why is the repeal of the line of credit such a big deal to you?

Mr. RAINES. It is not a question of whether it is a big deal to us; it is a question of investors. And I agree with you that it is symbolic, but symbols are very important.

Investors look to see whether there are certain entities in the United States that qualify to issue debt in what we call the agency market. And the agency market in the U.S. is not made up of Government agencies. It is made up of privately owned companies who have been asked to serve a public purpose. And so that is the vast majority of entities who issue in that market. And investors look for the indicia of, are you or are you not eligible to issue in this market. And this market is between Government securities and ordinary corporate securities, a lot closer to the ordinary corporate than it is to Government.

If you begin to take away indicia of eligibility in that market, you can undermine your ability to sell into that market. And the whole array of criteria that we have, and indicia that we have, are like a woven cloth. Can you take out one thread? Well, certainly. Does it have the potential of beginning to unravel the entire cloth? Absolutely.

So that is the issue. It is symbolic and if it has no cost to the Government, the question we would raise is, why take the risk? Why take the risk that investors would begin to see that something has fundamentally changed in the relationship of all of these issuers and the entity that chartered them?

Chairman BAKER. One financial question just on product expansion. I understand the pursuit of home ownership helping to facilitate for individuals who otherwise would be excluded from the process. But to enter into a pilot project basically with Home Depot to finance jacuzzi purchases and sun room expansions does not really facilitate home ownership. That is, at best, at the fringe of

home equity lending. Why would Fannie want to engage in that type of market activity?

Mr. RAINES. We don't.

Chairman BAKER. You have a pilot program with Chevy Chase Bank that does that. Chevy is the one that extends credit; they in turn sell the paper to you. Is that right?

Mr. RAINES. No, that is not right. The Chevy Chase example is an excellent example where a small bank decided to compete with a giant company. Chevy Chase Bank, a local bank in Washington, wanted to compete with the General Electric Company for the business of Home Depot, and they came to Fannie Mae and said "Would you be our partner in competing? And what we want to compete on is, Home Depot wants to help people remodel their homes. And what they would like to do is provide them not only materials, but also a contractor and the loan to help them finance improvements to their homes."

So they came to us and said, "Will you help us compete?" So little Chevy Chase Bank went and competed against GE and beat them. They provided lower interest rates and better service.

Chairman BAKER. Because they were partnered with you guys, though. Was that not somewhat a costing advantage?

Mr. RAINES. No, it was not a costing advantage. What was the real costing advantage was that the Chevy Chase turned out to be much more efficient than the giant corporation. They beat the giant corporation. The giant corporation was none too happy.

Chevy Chase never had an agreement with us to sell spa loans to us. It does not today. It was never part of any arrangement. It has always been on home remodeling.

There is a separate business, in that Chevy Chase competed with the giant corporation to provide those kinds of loans, which Chevy Chase would have kept in their own portfolio. There has never been any suggestion that they were selling those loans to us.

Chairman BAKER. But you do buy the home remodeling paper?

Mr. RAINES. We have bought second mortgages for thirty years.

Chairman BAKER. Right. In other words, stated differently, Chevy Chase extends the credit which they turn to you and sell the paper for home improvement. At question is, is the spa home improvement or is it aluminum siding? Is that how you break it out?

Mr. RAINES. No, Mr. Chairman, I don't think anyone would say that putting in a jacuzzi would constitute something that you would put a mortgage on the house for.

What we are talking about is honest Americans who cannot afford to have big-time contractors come and do their home improvements, so they go to Home Depot where they can get the materials much less expensively, where they have someone to help them pick out an honest contractor; and what they want is to be able to get their loan in the same place. They do not want to have to go and find out that they cannot get a loan.

Here is a company trying to help the average family, because for most families this is how they improve their homes. They don't sell them and move off to a fancy neighborhood. They fix them up.

And I think what Chevy Chase Bank did was outstanding, the fact that they beat a giant multinational corporation. We should be proud of that. It showed great initiative on their part, and I think

we did what we were supposed to do, which is to respond to the primary market; when they have a new idea and they come to us for help, we should help them.

Chairman BAKER. Excellent explanation. I still understand the principal operation is slightly different.

It reminds me of the television commercial where the actor is saying to the golfer, "Pick a number between one and a billion." And he says, "seven" and he says, "You're good; you're very, very good."

You are good, Mr. Raines, in explaining your position.

Mr. Kanjorski.

Mr. KANJORSKI. Thank you, Mr. Chairman.

My first question is, would you discuss—particularly Fannie Mae and Freddie Mac—the size of Fannie Mae and Freddie Mac debt relative to Treasury debt, and whether it is valid to compare the two?

Mr. Raines.

Mr. RAINES. Well, as you know, I spent a fair amount of time worrying about the Federal debt in recent years, and I consider it to be one of the major achievements of both the Administration and this Congress that we are now actually reducing the Federal debt.

But the comparison of our debt to the Federal debt is something I have never quite understood. Because if the Administration and Congress are successful in paying off all of the outstanding publicly-held debt, then every financial institution in America will have more debt outstanding than the Treasury, because the Treasury will have zero outstanding.

In reality, Fannie Mae and Freddie Mac do not create new debt. All we do is finance debt that is already outstanding. We can only buy a loan that has already been made. And when that loan was made, the lender borrowed short term to make that loan. When they sell the loan to us, all we can do is borrow long term. They pay off the debt they had, but we still have just that loan that is outstanding. So we do not add to the outstanding debt of the country at all.

Comparing us to the outstanding Treasury debt, I assume, is an implication that our debt is guaranteed in some way, and therefore, that that is an additional obligation of the Government. I hope that my testimony, and I hope Leland Brendsel's testimony, made very clear, that any obligation of the Government—financial obligation to Fannie Mae's debt is tenuous at best. And in my time as the Budget Director, I never ran into the budget concept of an implied guarantee. There is noplace in the Federal budget where we charge for an implied guarantee. There is noplace that we count up implied guarantees. We charge for real guarantees.

And even if there were a real guarantee of Fannie Mae's debt, under existing budget accounting rules, the cost would be zero, because there is no conceivable default under the credit scoring rules that the Government uses for complete guarantees.

So, I have never understood this argument, other than it is to compare us to a big number and to say that our debt is a big number, which we admit. But we operate in a big market. There are $5 trillion of mortgages outstanding. The one thing we know is that even if the worst fears of our critics were realized, we could never

have more than $5 trillion of debt outstanding, because that is all of the mortgages that exist.

Mr. KANJORSKI. Mr. Brendsel.

Mr. BRENDSEL. Congressman, if I could summarize this way, the decline of Treasury debt and the increase of Freddie Mac obligations, and Fannie Mae's, is good news. It is good news for the Nation. On the one hand, with the prosperity in the economy, with the sound fiscal management, Treasury debt is declining. On the other hand, with the sound economy, with the growing economy, home ownership rates are rising and, with that, mortgage loans that enable people to buy those homes are rising, and the business for Freddie Mac and Fannie Mae.

After all, all of our obligations, really nearly all of our obligations, are mortgage loans on people's homes. And they are what is backing all of our securities that we issue in the form of mortgage-backed securities or in the form of our debt obligations outstanding. And behind that is equity on people's homes, their down payments, and the growing equity.

As a result, I think it is great news. It is apples and oranges to compare Treasury debt with Freddie Mac and Fannie Mae debt. And, indeed, as Chairman Raines has already said and I said in my opening remarks, frankly, we are one of the strongest financial institutions in the country, if not the world, because of the fact we are in this one line of business.

There is no risk of insolvency and loss to the taxpayers, and indeed there is no guarantee to the United States taxpayer surrounding any of our obligations.

So with that, I am not certain what else I could say, Mr. Chairman.

Mr. KANJORSKI. Mr. Hage, what would the effect on the housing financing marketplace be if the Federal Home Loan Bank system were not involved? What if the Federal Home Loan Bank system were chartered or commissioned to do something else, primarily economic and community development?

Mr. HAGE. I am not sure I heard all the question, Mr. Kanjorski.

Mr. KANJORSKI. What kind of impact would occur on the housing finance marketplace in the United States if the mission of the Federal Home Loan Bank was redirected out of housing and toward economic and community development?

Mr. HAGE. The impact in some respects would probably be minimal, because community banks today are heavily engaged in economic development lending. We are the source of credit for Main Street businesses, farms, and other economic units of production in our local communities.

The increasing role and value of the Federal Home Loan Bank system, due in large measure to the expansion of eligible collateral in the bill just passed, allows and gives banks even greater power to continue to provide that source of economic lending in our communities, as well as continue our housing lending.

If the mission or the definition of mission were changed to be very narrowly defined and forced a focus on economic development at the expense of housing, that would be a mistake.

Chairman BAKER. Thank you, Mr. Kanjorski.

Mr. Riley, you are next.

Mr. RILEY. Thank you, Mr. Chairman. Thank you gentlemen. I enjoyed your opening statements.

But I am somewhat concerned, especially, Mr. Raines, with some of the rather bold statements concerning both this bill and the testimony of Under Secretary of the Treasury Gary Gensler. On a number of occasions, Fannie has called this bill "anti-housing" and continues to state that the bill would increase mortgage rates. Fannie called Gary Gensler's testimony regarding the issue on this bill as "inept, irresponsible, and unprofessional."

We know that Fannie apologized for those remarks. However, a week later, Fannie said that Gensler's comments had cost 208,000 families a chance at home ownership.

I would like to point your attention to a chart, if you would, over here. I hope you can see it that far away. The chart tracks thirty-year fixed conventional mortgage rates for the period of February 25, 2000, through May 11, 2000.

This bill was introduced on February 29th of this year. The week before the bill's introduction, the average thirty-year fixed conventional mortgage rate was 8.31 percent. The week after the bill's introduction rates actually fell on average down to 8.27. One week after Gensler's testimony, rates had fallen by 1 basis point. In fact, rates either fell or leveled off until over three weeks ago when the financial world began to speculate that there would be an increase in the Fed funds rate.

I guess my question is, the Federal Reserve and Alan Greenspan have raised the Fed rate 165 basis points in the last year, and it is anticipated they will probably raise them again today a quarter to one-half a point. It would seem to me that those rate increases would have much more of a direct effect on your cost of funds than anything in this legislation.

That being the case, would Fannie characterize the Fed as being antihousing or irresponsible? Does Fannie accuse the Fed of barring hundreds of thousands of Americans from home ownership? And if not, why are these comments reserved only for those that merely want to raise the issue of increased scrutiny for GSEs?

Mr. RAINES. Congressman, let me repeat what I said in my opening statement, that we do not find any objection to oversight activities. We believe what this subcommittee is doing is entirely appropriate and timely. We also have no objection to our regulators or other agencies exercising their responsibility to ask questions and make proposals. That has never been our concern.

Our concern is that if legislation is passed that actually changes our charter and causes our costs to go up, then that will have a negative impact on home buyers.

All of us have to deal with the circumstances of the markets as we find them. Rates may go up and rates may go down. The Fed may find, for good and sufficient reasons, that they have a need to slow down the economy or to speed up the economy. The question, though, is, should housing suffer an additional burden? Should rates be higher than they otherwise would have been?

So we do not ask that the monetary policy be directed solely to expanding home ownership. Monetary policy has to have a much broader purpose, but we shouldn't do anything that adds on top of

that additional costs that otherwise wouldn't be there. And that is our only concern.

Mr. RILEY. Well, there was certainly dialogue or rhetoric that was coming out of Fannie for the last two or three months that seemed to be directed specifically at this bill. And I think it is a little disingenuous on Fannie's part to say that this bill, or Secretary Gensler's testimony, had cost 200,000 Americans the opportunity or the ability to own a home, or to say that the basis of any increase in mortgage prices was because of some bill that we are only considering here. And I think that if there is going to be an attempt by this Congress to work with your organization to try to effect any kind of change, any kind of systemic risk change that we might think is appropriate, I believe Fannie is going to have to not only be a participant in the process, they are going to have to lower their rhetoric somewhat to the point that we are not accused of trying to damage home ownership in this country.

Mr. RAINES. Well, I don't think that there is any doubt that we need to have a very considered view of any proposal, such as the bill before the subcommittee today. And I don't believe we have ever accused this subcommittee, or any Member of this subcommittee, of trying to damage home ownership.

But, I think it is also important to remember that we are asking investors around the world every day to invest billions of dollars in American homes. And we are asking them to buy debt that will be outstanding for a long time. And we are asking them to do that on an understanding of what the arrangements are behind that debt. They have a right to have some stability in those arrangements. They have a right to know what they are getting themselves into.

So our concern, as I said, has to do with what is happening to the actual charter. If there is a proposed change to the charter that will change the arrangement in a way that is unfavorable to our ability to raise funds for home ownership, then we think we have an obligation to point that out. And it is a very fragile arrangement that exists in the marketplace and the capital markets now have many opportunities to invest their funds. They do not have to invest in home ownership in the United States. They could invest in home ownership in their own countries, but they have chosen to invest their dollars in home ownership in the United States; and we are simply saying that we need to exercise care in changing the arrangement that has worked so well that it has induced them to invest so much. And be sure that we are willing to assess the risk appropriately.

Chairman BAKER. Your time has expired, Mr. Riley.

Mr. BRENDSEL. Congressman, Mr. Chairman, may I make a comment here?

Chairman BAKER. Please.

Mr. BRENDSEL. Freddie Mac happened to be in the markets the day of that hearing, marketing a debt security. And, indeed, we have experienced significant success over the last few years in expanding our investor base worldwide to foreign markets; approximately a third of our debt securities are now purchased by international investors.

And, indeed, when we were in the markets that day, I was in our trading room watching the offering, and I saw the impact on the market of our offering. It really did disrupt the market. It caused confusion, I would say "uncertainty" among investors—probably investors that do not know this system as well, do not know the entire process, the entire committee and legislative process.

And indeed, all I could say is that regardless of the specific reasons, I have no doubt that the uncertainty created by how some of those comments were handled really was concerning to investors.

I might also add that if you look at some other statistics, some other charts, they would show a somewhat different story, not in terms of conventional mortgage rates, but, for example, if you were to compare rates on Government—Treasury, Government-guaranteed, mortgage-backed securities, Ginnie Maes, compared to conventionals, you would see again the impact of recent events.

Mr. RILEY. Mr. Chairman, will we have an opportunity to make a second round?

Chairman BAKER. Yes, sir. If you can stay, we will have a second round.

Mr. RILEY. Thank you.

Chairman BAKER. Mr. LaFalce. I'm sorry, he is not here.

Mrs. Maloney. Nope.

Mr. Watt, do you want to get in on this? No?

Mrs. Jones.

Mrs. JONES. I am not used to getting to ask questions this quickly. I was sitting back here.

Chairman BAKER. That is OK. You do not have to.

Mrs. JONES. No. I am going to ask some questions now. I want to start with Mr. Hage.

Can you discuss for me the impact of having H.R. 3703 lump all three GSEs into one category in terms of regulation, and so forth?

Mr. HAGE. We believe there are distinct differences in terms of the Federal Home Loan Bank structure and the organization of Freddie and Fannie. The Federal Home Loan Bank is a cooperative organization, not a stock—privately funded like Freddie and Fannie. Membership functions in the Federal Home Loan Bank system by members having access to and using the product that we offer—the focus, I believe, is different. The mission is different, and the way we achieve it is different.

Mrs. JONES. So, therefore—short answers, because I only have five minutes, go ahead—do you oppose or support this lumping together?

Mr. HAGE. We would oppose lumping together.

Mrs. JONES. OK. That was a good short answer. Thanks.

Let me go now to Mr. Raines and Mr. Brendsel.

There has been a lot of discussion and debate about your automated underwriting system. Some entities have complained that your systems leave out potential homeowners. Could you respond? Short as you can, guys. Come on.

Mr. BRENDSEL. I, in fact, think that automated underwriting systems have had the benefit and will continue to have the benefit of further reducing costs, making the system fair, more objective; and indeed our experience has been that it expands the opportunities

for home ownership when combined with the human judgments that go along with those automated underwriting systems.

But there is no doubt it reduces costs and increases the availability of mortgage credit, particularly as you try to expand into low-income neighborhoods where the cost related to making a mortgage loan and financing it in the secondary market is so very important.

Mr. RAINES. There is no question that Fannie Mae's desktop underwriting system has expanded the range of loans that we purchase. We have found underwriters who will say that we had no idea Fannie Mae would purchase a particular loan.

But also we have introduced a whole series of products that we would not have felt comfortable introducing unless we had a Desktop Underwriter helping us to assess the risk. So we believe that automated underwriting has been a valuable tool for expanding availability of mortgage credit to many people who would otherwise not have qualified for it.

Mrs. JONES. Talk for a moment about a complaint by some of your detractors, or people in the industry, about mortgage insurance and the position of Fannie Mae that you have to have mortgage insurance in order for them to purchase or for you to purchase these loans.

Mr. RAINES. Well, as I mentioned before, mortgage insurers are key risk-sharing partners of ours. In 1994, in fact, when we expanded the range of loans that we would buy to include loans with as little as 3 percent down, in other words, to help to protect us against a relatively new risk for us, we expanded the requirement for mortgage insurance. We said you had to purchase more mortgage insurance for a loan such as that.

When I became Chairman, after I came back from the Government, we had just completed a study that identified we did not need as much mortgage insurance as we had required in 1994; our experience base had grown and we did not need as much coverage. So we reduced that coverage.

When we increased the coverage, I don't remember there being any complaints from the mortgage insurance industry. But when we reduced the coverage, when we said you don't have to buy as much coverage, we got a lot of complaints from the mortgage insurance industry. They were disappointed that we were not requiring that their product be bought as frequently. And because 80 percent of the mortgage business product involves insuring either loans that Freddie Mac buys or Fannie Mae buys, this is a market of some importance to them. We are essentially their market, because we are required to use it in this part of our charter.

But the accusations of our trying to get into the mortgage insurance business are, of course, false. We don't intend to do mortgage insurance. We are their customer. We only want them to give us the best products that are available at the lowest possible costs to meet our risk-sharing needs.

Mrs. JONES. Can I go one more question?

Chairman BAKER. One more quick one.

Mrs. JONES. OK. Deal with, for a moment, the issue of mission creep.

Mr. RAINES. I can do that very quickly if you put up chart number 20.

Mission creep appears to be a concept that I am not quite sure exactly what it means, since we have a charter that sets our mission and we have regulators who enforce the charter. But the best answer to mission creep with regard to Fannie Mae is to look where our assets are. And if you look to see what our assets are, they are exactly what you would expect of a secondary mortgage company. Eighty-eight percent of our assets are single family mortgages, 2 percent are multifamily mortgages, the remainder is cash and liquid assets which every financial institution is required to have, and that is about 8 percent of our assets. We do not have any mission creep assets that are on our books.

So I am not sure what it means, unless what they mean is that you used to buy only certain kinds of mortgages, and now you are buying other kinds of mortgages. We used to buy only mortgages with 20 percent down; that is true. We now buy mortgages with as low as 3 percent down. We used to require perfect credit; that is true. We now say you do not have to have perfect credit. We used to have most of our mortgages come from outside of central cities; that is true. We now have a lot coming from inside central cities.

If that is what they mean by mission creep that we are doing, then I would simply point them to the charter that this committee voted on in 1992, which mandates that we try to extend our service to all parts of the mortgage market.

Chairman BAKER. Can we wrap up here, please? If we can, we will do a second round. People have been here for so long, I hate to make them wait longer.

Mr. Ryan.

Mr. RYAN. Thank you, Mr. Chairman. I enjoyed the testimony.

I had a different line of question planned, but I was intrigued with your line of questioning with Mr. Riley, my colleague, the fact that the introduction of this bill purportedly raised the cost of mortgages.

I think a representative of your company, Mr. Raines, at a conference in front of the mortgage bankers, said that the mere introduction of this bill has caused an increase in your cost of funds, which I understand is low relative to private entities, and caused an increase in the cost of home purchasing for average Americans.

In a recent *National Journal* article, it said that Fannie's and Freddie's return on equity in 1995 and 1999 was 24 percent compared to 15 percent for large banks, 12 percent for thrifts and insurers, and 17 percent for securities firms over the same period.

Now, this consistent earnings growth and return on equity is wonderful. I think you should be proud of that. That is a good thing. That is what private companies should be doing. But we are also assuming that then Fannie has been passing on the profits to its shareholders, regardless of the cost of borrowing funds, which is what an entity should be doing.

Getting to the point of whether or not the introduction of this bill, this kind of discussion, raises the cost of home buying, isn't the answer also included in whether or not you are interested in passing the costs on to the consumers to protect that 25 percent profit rate; or is it really fair to say that this legislation would make in-

terest rates increase if you make the ultimate decision on either using your return on equity to keep rates low, passing them through to keep rates low, or enhancing shareholder wealth?

Which comes first is the question.

In my opinion, from watching your give-and-take with Mr. Riley, it would seem that your mission and your capability is to offset any of these increases in the cost of funds by using more of your return on equity, or a greater percentage of your Government subsidies, keeping rates low rather than hitting that 25 percent target.

Mr. RAINES. Mr. Ryan, we do not believe that the mere introduction of this bill raised interest rates. We believe that the investor community had great concern that legislation such as this might be enacted. It is the enactment—not the introduction, not the discussion, the enactment of legislation is what investors are concerned about. Since they have to buy debt and hold it for a long time, they have to make their own calculation what are the chances it is going to be enacted. So it is the enactment that is the concern.

In terms of our income—and I think this is an important point; and I know you share the view that all additional costs, all taxes, all regulatory burdens on corporations are not paid for by the corporations, they are paid for by consumers—the important point here is, what is happening with our profits?

The assumption in your question was that we write a check to the shareholders for our profits. Indeed, 28 percent of our pretax profits last year went to Federal income taxes, 50 percent went to increases in our capital required to meet our strict capital requirement, 22 cents on the dollar actually went to shareholders. So our shareholders basically have taken the view, "keep the money in the company, keep doing your job, keep serving your mission."

So it is not accurate that somehow we can translate profits into overcoming an impact in the market caused by the legislation.

The last thing I would simply say is that the cost of mortgages is not set by Fannie Mae, and it is not set by Freddie Mac; it is set by the markets. When lenders take our mortgage-backed securities, we do not sell them to the market, they do. So the price they get is given to them by the market. The price that we have when we buy out of the market is set by the market. And so all of us are having to ensure that the market works well, and we simply have to react to what the market gives us.

Mr. RYAN. Mr. Raines, I would like to switch now. I am interested in this debt issue and this debt debate we seem to be having.

We are in the middle of a big chart war, it seems, these days. I see in your testimony in chart 19 you talk about the debt that Freddie and Fannie have, and I would like to go to the issue of repurchasing your own mortgage-backed securities. I believe, in 1993, you started doing that with a fairly steady pace. Some critics of the GSEs argue that when Fannie Mae or Freddie Mac issues debt to repurchase its MBSs from the private sector, it is unnecessarily increasing the risk to taxpayers, that that is excess debt that does not go toward fulfilling your mission statement, and that it is debt that is unnecessarily borne by taxpayers with this implied credit that we obviously have various opinions on.

Isn't the issue not how much debt is outstanding in the economy, which is, I think, what your chart 19 shows. Isn't the issue how

much GSE debt has been issued and whether that debt, the excess debt, whoever's measurement that may be, is needed to meet your GSE mission?

So my question is, is the debt that you incur from repurchasing mortgage-backed securities above and beyond what you need to fulfill your mission? I don't think this panel is saying any GSE debt is bad. I think the panel is concerned about some GSE debt, on top of your critical mission debt, is an unnecessary risk posed to the taxpayer and goes beyond and above what your original mission fulfillment is.

Chairman BAKER. We will have to wrap up with—and let Mr. Raines answer fully, but I suggest that we have one vote. At the conclusion of Mr. Raines's remarks, we will briefly recess.

On the Democrat side, Mrs. Waters, you would be up next for a question if you can make it back after the vote, and we will just pick up at that tempo.

Mr. Raines.

Mr. RAINES. I can answer now?

Chairman BAKER. Yes.

Mr. RAINES. Put up number 2. I will do this quickly so you can go vote. It is an excellent question, and I think it is one that we need to have clearly understood if the functioning of the secondary market is to be understood.

First, we try to offer investors the kind of securities they most want, because if we offer them the kind of securities they most want, they will charge less money. And not all investors are created equal; some investors like to have all of the volatility along with the additional income you get from a mortgage-backed security. There is volatility, because people can repay that mortgage at any time, and therefore it is hard to decide what that is worth.

And so some investors will want mortgage-backed securities, but there is a limited number of them.

There are other investors who say, I do not want all of that volatility. I am willing to take a little bit of what we call "optionality" in my debt, but I don't want a lot. And for them, we offer our callable debt. And others will say, I do not want any optionality; I want it paid back on a particular date exactly on that date. And for them we offer our bullet debt.

So we offer investors what it is they want, because if we do not offer what they want, they will charge us more money.

Mr. RYAN. How does that deal with you repurchasing your own mortgage-backed securities and whether or not that transforms into your reaching your mission statement?

Mr. RAINES. Excellent question, and that is the second chart.

Mr. RYAN. A lot of charts in this.

Mr. RAINES. Old habits.

This one shows what we believe to be our fundamental role. Our fundamental role is to transform the risks that are inherent in consumer mortgages into the kind of risk that investors want. And the question has come up, are we increasing the debt as we do that? And let me just walk you through the process, if you will; it will take me less than one minute.

This shows an example of a lender originating a billion dollars in mortgages. So we have a billion dollars of debt that has now

been created and that lender has gotten a short-term loan from their bank to pay for that. They swap those for mortgage-backed securities which is the predominant way it is done. They say Fannie Mae, here are the loans; you give me mortgage-backed securities.

They hold those securities or they sell them to Wall Street. Wall Street now takes out a short-term loan, pays the lender for the mortgages. That lender pays off their warehouse loan. The market still has that same billion dollars of debt outstanding, that same billion dollars financed by a billion dollars. Wall Street sells part of that to Fannie Mae and part of it to other investors. So we buy a part of it, and other investors buy a part of it, and then we issue debt to pay off Wall Street, and the other investors don't pay off Wall Street.

So here we are. There is still a billion dollars of loans outstanding. There is still a billion dollars of debt that has been used to invest in them. There is no new debt.

Mr. RYAN. I think that is a very accurate statement and I agree with what you just said.

I guess the question is, it is the difference between your owning your mortgage-backed securities at an implied taxpayer risk versus a private-sector holder of your mortgage-backed securities. I don't think the issue is increased total debt in the market.

Does it increase your debt and, therefore, implied taxpayer risk?

Mr. RAINES. We guarantee the mortgage-backed securities just as we guarantee our debt. So it does not matter in terms of the risk to Fannie Mae whether or not it is in the form of a mortgage-backed security or debt. It is the same guarantee on both.

So if you believe there is a risk in there, it is the same risk no matter what form it is in. In fact, we would argue that Fannie Mae is a better holder of the mortgage risk, because we have so much more data, so much greater ability to hold it, that the risk to the system is actually reduced; because if these loans were being held by your local thrift or your local bank, who have lesser ability to manage them, there is more systemic risk than if they are held by Fannie Mae or Freddie Mac. And remember, those are institutions that have Federal guarantees, whereas we do not.

Mr. RYAN. I think the Federal guarantee—excuse me.

Mr. BRENDSEL. If I may comment, there are two other points I would make that relate to this. One is the natural investor for callable debt is sometimes different than the natural investor for a mortgage-backed security. Freddie Mac and Fannie Mae are always in the process of finding who is the most attractive investor for a particular kind of security.

Chairman BAKER. If I may interrupt, we are down to five minutes.

Mr. BRENDSEL. The second issue would be whether or not this affects anything about the safety and soundness of Fannie Mae or Freddie Mac.

Chairman BAKER. We will come back to this explanation when we come back. We are down to five minutes on the vote. We will be right back. Thank you.

[Recess.]

Chairman BAKER. If I may ask individuals to please take seats, we will reconvene our hearing. Mr. Brendsel, when we suspended our activities here, Mr. Ryan was in an exchange. I think he would request the ability to restate his question and then have you respond from the start.

Mr. Ryan, you are recognized.

Mr. RYAN. I am sorry we cut you off before the vote happened. We wanted to make our vote.

The question is, and I saw——

Chairman BAKER. Excuse me. If I could get those back doors closed, it would help with the noise so that the witnesses are able to hear properly.

Mr. Ryan.

Mr. RYAN. The question, and it is a very simple one—I think this is very fascinating. You had the chart that showed the callable, the bullet, and the mortgage-backed security debt. And tell me if I am misparaphrasing you, Mr. Raines; the riskiest debt was the mortgage-backed security debt, correct?

Mr. RAINES. I think it would generally be considered as having the greatest volatility and greatest optionality.

Mr. RYAN. The question is, does the issuance of mortgage-backed securities and the repurchasing of your mortgage-backed securities put another person into a home, period? Does that advance the goal of home ownership and put another person into a home? That is question number one.

Question number two is, if it does not put another person into a home, is that not excess debt above and beyond the debt that is needed to put people into homes or to fulfill the mission of the GSEs, the primary mission of which is the secondary market?

Mr. RAINES. An excellent question. And I think the answer is very clear that the operation of our portfolio is vital to our achieving the reduction in interest rates that we achieve in the marketplace. Because when we buy mortgage-backed securities, we are one of the investors who are adding to the demand for mortgage-backed securities. Without our buying the mortgage-backed security, interest rates would be higher, because the demand for mortgage-backed securities would be less.

And it was never shown so well as it was shown in the fall of 1998, when the number of people who wanted to own mortgage-backed securities disappeared, and billions and billions and billions of dollars of existing mortgage-backed securities came into the market.

So, if you were trying to buy a home in October of 1998, if Fannie Mae and Freddie Mac had not had mortgage-backed portfolios, you would have seen interest rates in the United States soar, and it would have prevented people from getting a mortgage in October of 1998.

So the operation of our portfolios is vital in maintaining the flow of capital and achieving that 25- to 50-basis-point reduction in interest rates.

Mr. RYAN. I clearly understand that the operation of the portfolio is critical to that mission.

Is the operation in the portfolio specific to the issuance and repurchase of mortgage-backed securities in and of itself critical to

fulfilling that mission, meaning putting another person in a home that otherwise would not be put into a home?

Mr. RAINES. Absolutely, because there is a distinction that some critics have made between our buying a whole loan and buying a mortgage-backed security. And they would say if you buy a whole loan, that is OK; but if you buy a mortgage-backed security, that is not OK.

It is a false distinction, because all mortgage-backed securities are groups of whole loans. So it is exactly the same activity when loans are put in mortgage-backed securities by lenders and sold to investors, that is, the vast majority of loans in our marketplace are put in mortgage-backed securities first.

They are not sold to us as whole loans. The vast majority are put into mortgage-backed securities. And so when we buy them or anyone else buys mortgages, they are predominantly buying them in mortgage-backed securities, not as an individual loan.

Chairman BAKER. Mr. Ryan, can you wrap it up now?

Mr. RYAN. One more point, if I could, Mr. Chairman.

So you are saying, by the GSEs repurchasing mortgage-backed securities, that contributes to lowering interest rates as opposed to a private entity buying those mortgage-backed securities? Is that what you said?

Mr. RAINES. The key distinction, you said "repurchase." The idea of repurchase implies that we would be the one who sold the mortgage-backed securities. But it is the lender who sells them; we only buy them essentially when other reinvestors do not want them.

Mr. RYAN. I think you mentioned $493 billion, everyone combined, in 1999. That $493 billion purchase of mortgage-backed securities are mortgage-backed securities that otherwise would not have been purchased by the private market; is that essentially what you are saying?

Mr. RAINES. No. What we are saying is, if you add the bid of Fannie Mae and Freddie Mac into that market, we make the value of that mortgage-backed security higher and the interest rate lower. The market would have cleared at some level, but it would have cleared at a much higher interest rate. By our buying them, we are clearing that market at a lower interest rate to the consumer.

So the loans would have been bought by somebody.

Mr. RYAN. They would have been bought, but the effect would have been higher interest rates?

Mr. RAINES. The effect would have been higher interest rates.

Mr. RYAN. This is fascinating. I understand that I am out of time, but thank you.

Mr. BAKER. Ms. Waters would be next, but she is not present, so I recognize Mr. Sweeney.

Mr. SWEENEY. Thank you, Mr. Chairman.

I thank our guests for their testimony. I have a couple of questions I would like to address to the panel regarding just to get a sense of your position on oversight and risk management and what is proper, and I would like very brief answers, and then I would like to make a point before I conclude.

Mr. Hage, you mentioned in your testimony that the task of capital restructuring is going to be quite a daunting task, and it will

indeed present the greatest challenge to you. Could you very briefly give me some of the key points?

And you also mentioned the need to maintain flexibility, and I think it does go to the heart of the whole notion of whether we need to reform and in what particular areas we need to, whether it needs to be a macro or micro approach. Could you give some key points on flexibility, what your greatest concerns would be in terms of loss of flexibility if we were to move forward with this legislation?

Mr. HAGE. The Federal Home Loan Bank system historically has been a closed capital system. By that I mean, the member has to put capital into the system whether or not they use it. The new definitions of capital and the new requirements of capital under the financial modernization bill have changed that in a positive way, but also in a significant way. The challenge is to construct the capital in a way that is salable to its members, so they will in fact buy the capital, and yet achieve the flexibility of utilization of capital by members so that if they are not using the system, they are redeploying that capital.

Mr. SWEENEY. And it aids, as you said in your testimony, that the regulatory process currently provides enough protection to ensure that the Federal Home Loan Banks are sufficiently capitalized, correct?

Mr. HAGE. I believe it does, yes.

Mr. SWEENEY. OK.

Mr. Brendsel, I understand, and we have heard it a couple of times, that you have worked with the Chairman and his staff, and I am suspecting that we pretty much agree, or you pretty much agree that promoting great market discipline transparency is an overall goal that you would sign on to in support?

Mr. BRENDSEL. Absolutely.

Mr. SWEENEY. And I want to thank you, because your staff has been very helpful.

Mr. BRENDSEL. Thank you.

If I could add to that, I have always supported a very strong safety and soundness regulator, independent and credible. I frankly do not believe that the bill as currently structured would enhance those basic principles.

With regard to the transparency and the availability of information to the market, to investors about our business and risk management practices, I would actually also like to mention something additional. In fact, I believe that Freddie Mac is a leader in transparency and disclosure about our business activities and risk management practices.

Indeed, we recently asked for an independent review by PricewaterhouseCoopers of our disclosures, and they have recently completed that review. I am in the process of obtaining a written copy of it, but I can give you the bottom line conclusion.

They took the top institutions, banking and financial institutions in the country, regarded for being best practices in disclosure; they compared our disclosures against those—to the marketplace, to investors—and they ranked us in the top third. Top three.

Mr. SWEENEY. You also—Freddie Mac has also recently announced antipredatory lending practices. Maybe you could briefly

give us some of that information and your rationale. And be brief, because I need get to Mr. Raines with some questions.

Mr. BRENDSEL. With regard to—I'm sorry?

Mr. SWEENEY. The antipredatory lending guidelines that you have just initiated.

Mr. BRENDSEL. Yes, we have explored the subprime sector, and in particular, in addition, lending activities in parts of that sector. Indeed, there are good parts and there are bad parts of that sector; and in fact, we became troubled with some of what we saw, and we commissioned—in fact, we conducted a thorough review of those practices. And we recently issued guidelines to our lenders, first of all, requiring credit reporting on all of their borrowings.

Mr. SWEENEY. I would like to stay with you, but I am running out of time.

Mr. Raines, I am hopeful that your people read the testimony or read the statement that I made at the March hearing and understand that my position has been very substantially one that I have been quite hesitant to move forward here, because I'm not certain that the system is broken and I do not want to try to fix something that isn't. But I need to make that point to you.

You have said three times in your testimony that oversight is key to safety and soundness, and you said that you are concerned, not with these hearings, but with actual change. And yet my office has been barraged by constituent letters, mailgrams of this nature, e-mails. One such e-mail reads as follows: "Last week I received a telephone call from an individual who stated that he was with the Fannie Mae Foundation, seeking my agreement to join the foundation in opposing H.R. 3703. I also have received substantial mail from those on the other side."

I have a couple of questions. One is, I would like to know where you obtained the list that you solicited this kind of constituent mail. Second, to what Members did you do this? And thirdly, as a freshman Member of Congress, my office is often burdened beyond the norm. This certainly causes me great concern, and I am not one who was necessarily moving precipitously, if you felt Members were, and I do not quite understand your tactic.

Mrs. ROUKEMA. Will the gentleman yield?

Chairman BAKER. If I may, Mr. Sweeney, so he can see to respond, I ask that the boxes be moved.

Mr. SWEENEY. That is the problem I have now in my office with a lot of things I need to do, because I have to respond to those letters.

Mr. RYAN. Could I ask unanimous consent to move the boxes to the right, so we could see Mr. Raines as he gives his answer?

Chairman BAKER. Mr. Sweeney, have your staff remove the boxes.

Mr. RAINES. I feel like the judge in "Miracle on 34th Street" when they brought in the letters to Santa Claus and put them on the judge's desk.

Mr. SWEENEY. Well, this is no miracle.

Mr. RAINES. Democracy is a wonderful thing.

Chairman BAKER. Mr. Raines, you have a moment or two to respond. Mr. Sweeney has expired his time.

Mr. RAINES. Mr. Sweeney, I am delighted to respond.

We have been absolutely thrilled anytime we have asked for support for Fannie Mae and our activities at the response we get throughout our industry and throughout the Nation. And we did, in fact, contact constituents in virtually all of the districts of Members of this subcommittee, and perhaps beyond this subcommittee, and asked them to express their support for us and their concern about this bill.

Mr. SWEENEY. Where were those lists obtained?

Mr. RAINES. We bought them from commercial houses who have lists of homeowners in yours and other districts. But the tone of these letters I think is exactly appropriate, and let me read just the first two paragraphs:

"I wanted to rush you a quick note and let you know how much I appreciate all you are doing on behalf of homeowners and for home ownership in America today. Home ownership in America is at an all-time high, and that is due in large part to the policies that you and other Members in Congress have supported in recent years."

Mr. SWEENEY. Reclaiming my time, let me make this final point. You made the statement earlier that "We have never accused any Member of trying to damage home ownership", yet in this letter you, as well, say, "However, there is a bill today that has already had negative impact on mortgage costs."

That directly contradicts what you have said to Mr. Riley and to Mr. Ryan and to other Members. And I, as a Member who I think was more in the middle on this than any other Member, that may feel that there is not a need of great change, am offended by that.

Mr. RAINES. Mr. Sweeney, I think this letter is very clear. It does not accuse any Member of trying to hurt home ownership. It does say that this bill can have that effect. And it is not just Fannie Mae that believes this bill can have that effect; there are many people in the housing industry—certainly, I cannot believe that you are saying that we cannot critique the bill.

Chairman BAKER. Mr. Sweeney, can we can wrap it up?

Mr. SWEENEY. Let me suggest this, that if there has been an adverse impact on the market, it may not simply have been the hearing or the testimony of any of the witnesses in March; it may also be as a result of the actions of Fannie Mae, and I caution that you go very slowly here.

Mr. RAINES. With all due respect, I think that we are prepared to accept any criticism that we deserve. But just to be very clear on this letter, this letter does not criticize a witness; it does not criticize a Member.

The letter says very clearly, "There is a bill, H.R. 3703, that has already had a negative effect."

So we have tried to be very, very careful about the kinds of things that we say, and we try to be very, very careful here that our objection is to a bill that we hope will not be enacted. It is not to a hearing, not to a Member, not to a witness, not even to an idea; but it is to a bill.

Chairman BAKER. Mr. Raines, I do not want to arbitrarily conclude the discussion, but in fairness to Members we do need move on to others who have been waiting some time. And I think it is clear, the only persons to whom any correspondence may have ref-

erence would be myself and Chairman Leach as offerers of the bill. That would be it, as I have read the letter that has been transmitted.

So I understand the issue and I am comfortable with it.

Ms. Waters, you are next.

Ms. WATERS. Thank you very much, Mr. Chairman and Members.

First, I would like to compliment both Mr. Raines and Mr. Brendsel for their testimony today. I think that you have, in the best way that I have ever witnessed in this subcommittee, explained who you are, what you do, how you do it; and many Members who are sitting here today are understanding for the first time some of the intricacies of how you work and why now we all, I am sure, understand, based on your testimony, that you are at no great risk.

But I do think there is one little thing needs to be cleared up, and I am going to ask you to do that so that we can put this question about whether or not there was an increase in interest rates to rest.

I am very clear that what you have said is that there was an increase in the cost of the money that you borrow. I think the previous chart that was put up by my colleague on the other side of the aisle tried to compare that to the interest rates in the market, rather than looking at the cost to you.

You need to explain, I think, that, yes, there was this increase in the cost of borrowing and that you did not pass it on in any way. But there is a difference between what they show and what the experience was that was described by both you and the *Wall Street Journal* and other publications.

Will you please illuminate on that and explain, so that the Members of the subcommittee understand the difference and we can all be clear about it?

Mr. BRENDSEL. Well, let me start on this, and as I said before in this hearing, this morning, we were in the market that day. We did see an increase in the cost of our borrowings, and in fact we saw an increase in the yields on our mortgage-backed securities relative, for example, to Government-guaranteed mortgage-backed securities. There is no doubt in my mind that that is reflected in mortgage rates.

Now, there are other things that influence mortgage rates, the Federal Reserve actions that are influencing mortgage rates that you actually observe and record. In fact, I am not certain where this particular source of information came from.

Chairman BAKER. That is the Freddie Mac home page posting on Thursday.

Mr. BRENDSEL. But we do conduct a survey of mortgage lenders, and we study this a lot. And as everyone knows, there are a variety of influences on mortgage rates that cause them to change over time.

But it did increase our costs. It did increase yields on mortgage-backed securities and contributed. Otherwise, mortgage rates would have been lower would be a different way of saying it.

Ms. WATERS. Thank you very much. I would like to get this on the record.

I have been one of the greatest critics of Fannie Mae and Freddie Mac; and on more than one occasion, we have faced off about everything from ads to statements, studies, you name it. And I am going to continue to do that, so I don't want anybody to think that somehow I am going to support Fannie Mae or Freddie Mac in whatever they do.

I want you to put more money into my community. I want you to buy more of those loans in the secondary market. I want you to expand the way that you operate so—I mean, I want it to be understood that I think that it is incumbent upon all of us to make sure that we get the best that we can get for our constituencies. And for all of those who are involved in FM Watch, I would like to have the opportunity to interact with you and have you interact with my constituents in the same way that Fannie Mae and Freddie Mac have been doing.

So even though today I support you 100 percent in saying that there is nothing wrong here, there is nothing that needs to be fixed, and that, yes, if there is an implied thought in the overall community that somehow you are Government-backed, and if that inures to all of our benefit, that is fine. But as you said, I cannot calculate any implications and that is that.

But let me just close by saying that I can tell you that you have done well here today and let me tell you what the measure should be. Not my simply saying so, but when the Chairman admits it. He does not admit that very easily and when he compliments you, you can take it to the bank.

Thank you very much.

Chairman BAKER. I think that was a compliment. Thank you.

Chairman Leach, you would be recognized.

Mr. LEACH. Thank you very much.

Mr. Hage, in the proposed rules that are circulated by the oversight board for the Federal Home Loan Bank system, a stock will be tradable in such a manner that a single entity will be able to control an individual Federal Home Loan Bank.

Do you think this is appropriate or inappropriate?

Mr. HAGE. As the capital rules are being suggested and proposed and the notion of capital being more fluid than it has been in the past, there are serious questions that need to be addressed. It is of concern that—the notion that larger shareholders would have the power to control the system by the quantity of stock that they would own and be able to vote. It has also been a long-standing concern of those large members, who have had a large amount of stock, that have been denied the right to vote their stock. It is a matter that has merit on both sides and has concern on both sides.

Mr. LEACH. Let me stress to this subcommittee a couple of aspects about privilege, that this panel suggested we should maintain the status quo. One is that the Federal Home Loan Bank system is federally untaxed. Under the rules that are being promulgated within it today, an entity could take it over and therefore take advantage of its untaxed status. That is not the intent of anyone that I know of in the United States Congress, and it is an aspect that this subcommittee is obligated to comment upon.

Second, as Freddie Mac and Fannie Mae well know, both are exempt from the payment of State taxes. Fannie Mae is the most

profitable institution per employee in the United States of America. Freddie Mac is the second most profitable institution in America of any kind. And yet you are privileged from the payment of State income taxes.

So let me ask, is that fair, Mr. Raines?

Mr. RAINES. The determination to exempt Fannie Mae from the payment of State income taxes is, I think, grounded in public policy and not meant to favor the companies. But, it was one of the things that Congress did to ensure that mortgage finance could flow at the least expense, but I think, more importantly, was a concern that if you allowed the State in which we were located to levy a tax on us, that that would simply be a way to export that tax around the country. Whatever State that was would be able to collect a tax on all mortgages in the United States without their own constituents feeling a proportionate share of the burden.

So I believe, as a matter of public policy, that exemption was there to prevent that from occurring, to prevent one State from being able to collect taxes from around the whole country and bring them all into any one State.

From the standpoint of the company's activities, you know, we probably could engage in the same activities that other companies do to minimize taxation. Our effective tax rate is higher than that of most companies, because we cannot engage in the kind of activities, such as leasing and other things that can drive down your tax rate. So even with the exemption from paying State income taxes, our effective tax rate is higher than most of the tax rates of our critics. And I doubt that they would want to switch with us in terms of whose effective tax rate they would like to have.

Mr. LEACH. Let me ask a second question on arbitrage activities.

The Federal Home Loan Bank system leads the country in arbitrage. Fannie and Freddie are very high; Farmer Mac, on a percentage basis, is number one. So let me just ask your judgment on another GSE.

Do you think it is credible for Farmer Mac, a Government Sponsored Enterprise of approximately $50 million in capital, to have several billion dollars in arbitrage activity?

Mr. Brendsel, is that appropriate?

Mr. BRENDSEL. I can't speak with regard to Farmer Mac knowledgeably. I can say that we do not engage in arbitrage activities.

Mr. LEACH. You have never engaged in arbitrage activities?

Mr. BRENDSEL. We have never engaged in arbitrage activities.

Mr. LEACH. Well, you may recall getting a letter from me a few years back in which it was pointed out that on an instantaneous basis, that is, within seconds, Freddie Mac had taken down a given amount of money on a multiyear Government basis and purchased a Philip Morris bond. Is that not arbitrage?

Mr. BRENDSEL. That is not arbitrage.

Mr. LEACH. What is it?

Mr. BRENDSEL. Let me explain. Put Philip Morris off to the side.

Clearly, that was an error in judgment about the particular name that one invests in, given the amount of, I think, discredit it brought to what we are doing. We do make investments that are non-mortgage—in non-mortgage assets. They are a very small, but essential part of our mission. They are used to manage the cash

flow as well as to hold a small amount of capital in reserve to support——

Mr. LEACH. How is that managing cash flow if you buy a bond, the same duration, at the exact same moment that you take down Government money? Your access to the Government borrowing capacity? Is that anything except your stockholders taking the differential, which in the general term of art is considered arbitrage, although maybe in your definition it is a good investment in the Philip Morris bond?

I mean, is buying a Philip Morris bond, is that part of your mandate as a Government Sponsored Enterprise in housing?

Mr. BRENDSEL. Holding a small amount of our assets in high-quality, low-risk investments——

Mr. LEACH. Long-term, this was a long-term bond.

Mr. BRENDSEL. I can't recall the particular maturity of that bond. A vast majority of the maturities of our non-mortgage investments are short-term, ninety days or less. They are high-quality, triple A rated. They are done for purposes of managing the cash flows of the corporation and holding a capital contingency in reserve so that we can liquidate that investment and step into the mortgage market. And indeed we have shown historically that is indeed what we do.

We will, when we need the capital, step in; if we cannot go out into the capital markets and raise it, we sell off an asset, this small contingent reserve, and go into the market to buy mortgages and mortgage-backed securities.

Chairman BAKER. Mr. Chairman, I am reluctant to do this, but do you have one more to wrap up, sir?

Mr. LEACH. No, sir.

Chairman BAKER. Thank you, Mr. Chairman. I hope you do not remember that.

Mrs. Roukema, are you back? No.

Mr. Manzuilo. I am sorry. I don't know what I am doing. I was looking at the wrong list.

Mrs. Maloney is next.

Mrs. MALONEY. Thank you, Mr. Chairman.

Some critics of GSEs have charged that you are not doing all you are capable of doing to increase minority home ownership. Some have argued that banks actually serve a higher percentage of minority borrowers than the GSEs. Is this true? Is this a result of the GSEs only being able to buy loans that originators choose to sell them?

And I ask anyone to comment.

Mr. RAINES. I would love to start on this one.

Fannie Mae has had a policy over the last decade of ensuring that we focus on those who have not benefited from home ownership over this period. And we believe that we and the entire secondary market have been successful in beginning to make progress on the extraordinarily low home ownership rates that exist in the minority community in the United States. Virtually all minority communities in the United States have home ownership rates below 50 percent, whereas the white home ownership rate is around 73 percent. And we have made tremendous progress.

The chart that we have up here shows the actual change in our business mix over the period from 1993 to 1999 where you can see that our loans to African Americans are up 31 percent over that period; loans to all minorities up 16 percent. And loans to whites have actually declined in that period in our book of business. So we have made extraordinary progress over this time.

I have pledged over the next ten years that we are going to invest over $400 billion in moving up minority home ownership rates. We are committed to that as a company, and I believe that we will achieve that goal.

Mr. BRENDSEL. If we could leave that same chart up and I could talk to it for Freddie Mac at least.

Indeed, Congresswoman, as you said, we are in the secondary market. We do buy loans from originators; we do not make those loans directly. Nevertheless, that is not an excuse for any performance or lack thereof, and we are always trying to do better. In fact, I am very proud of Freddie Mac's record of service and particularly the progress in our record of service.

We could always get into debates over statistics and numbers and trying to compare the performance of one market to another, and primary to a secondary, and there is a lot of misinformation out there. But let me just say that our focus is to reduce the costs of getting the mortgage loan, the down payment, the closing costs, mortgage rates; develop innovative new products, outreach, education for minority families, potential home buyers. And indeed the statistic that I remember from our own that stands out is that since 1993, our purchase of loans that were made to African American families have increased by over 50 percent since 1993.

Mrs. MALONEY. Thank you.

Would you like to comment?

Mr. HAGE. Thank you, Congresswoman.

The Federal Home Loan Banks, through their affordable housing program, are deeply involved in making loans and grants, actually, to low-income people of all neighborhoods and of all sections of our country. In 1998, we awarded $199 million. Over 230,000 units of housing were funded since 1989. We are the largest single contributor to Habitat for Humanity affiliates in helping them rebuild homes and put families in homes.

So affordable housing is indeed a very strong part of the Federal Home Loan Bank program enhanced by our AHP funding. We are also supported by the activities of our members in individual communities who make loans daily.

Mrs. MALONEY. Thank you.

I would like to ask Fannie and Freddie, what are the ramifications of automated underwriting for minorities? Specifically, how do you ensure that automated underwriting is not so strict that borrowers with unorthodox credit histories are shut out?

Mr. RAINES. Well, one of the most important implications of automated underwriting for minorities is that, for the first time, we have a tool to eliminate explicit racial discrimination. The automated underwriting does not know what your race is, does not know what your accent is, does not know what where you live. It underwrites your application, based on criteria that in Desktop Underwriter we have validated as being racially neutral.

We have done an enormous number of tests to determine that the factors that we use are racially neutral; and indeed we have published the fourteen factors that we use in our system so that everyone can look at them and judge them. We also ensure that we are only looking at those things that predict default in mortgages and do that quite accurately.

But, we do not rely on automated underwriting solely. We always use automated underwriting to approve borrowers, but it can never disapprove someone. All it can do is refer them to a human underwriter. And we have a number of loan programs that explicitly take into account unorthodox credit histories where someone may not have the same credit cards and other things that would show up in the normal credit reporting, but they have diligently paid their rent and utility bills.

So we allow alternative underwriting standards to be used by human underwriters to be able to respond to the great diversity that we find out in the community.

So automated underwriting really is a way to reduce discrimination, speed up the process, and indeed free up the human underwriters to work on the harder cases, because they do not have to work on the easier cases, because our system exists.

Mr. BRENDSEL. We began developing automated underwriting systems back in the early 1990's. We have a database of roughly twenty million mortgage loans that we have purchased. In addition, we got a lot of data from other sources and developed what I think is an outstanding automated underwriting system.

But we do not rely on that, in and of itself, exclusively. Like Fannie Mae, we combine that with human judgment, human review such that no one is ever turned down because of a simple score.

In addition, to add to that, some of the—clearly some families have impaired credit histories that an automated underwriting system may penalize them for. It is because of the ostensive predictability of it. But what we have done is develop some additional mortgage products and programs like—what we call Credit Works that enables a family to go through a credit counseling education program and at the same time get a loan at a prime rate and give the family the chance to demonstrate that they can manage their credit and make their mortgage payment; and we have been very pleased with that type of product.

And indeed, I might also add that it is those types of innovative products and programs that would be, I think, interfered with by this particular legislation. Because it would require prior approval of all those innovative mortgage products by a regulatory process that would only stifle innovation and increase costs.

Chairman BAKER. Mr. Brendsel has exhausted your time, Mrs. Maloney, by a considerable amount.

Mr. Manzullo.

Mr. MANZULLO. Thank you.

On May 2, 4 and 9 my office also received anonymous boxes full of 500 envelope-sealed form letters expressing opposition to this bill. Two thousand letters in two weeks catches anyone's attention, but something did not smell right; so I had my staff call thirty of

the people who had written in. The first nine people knew nothing about the letter.

I then came across several constituents who remembered receiving a telephone call about having their name placed on a petition to Congress about decreasing the cost of home ownership and having Congress lower interest rates. Three of those constituents did not recall who contacted them, but they thought it was a not-for-profit affordable housing group.

Many constituents clearly remembered who contacted them: Fannie Mae, the Fannie Mae Foundation, and the Coalition for Homeownership. Some constituents received a copy of the letter with their name on it from the Coalition for Homeownership, and three had explicitly told them not to send the letter, but they did anyway. Some received a copy of the letter and had never been contacted about anyone sending the letter. Finally, some persons said that the name on the letter was a relative who had never lived at that address and they could not figure out how the name got attached to the address.

Most of my constituents were upset that their good name had been used by your company. I am upset also. No one knew that the letter was being sent on their behalf on a specific piece of legislation.

I have several questions, Mr. Raines, to ask you. What role has Fannie Mae's corporate headquarters played in this lobbying effort and exactly who makes up the Coalition for Homeownership?

Mr. RAINES. Congressman, we are quite direct about our involvement in contacts with Members here. We authorized the phone calls to be made. We asked people to authorize the sending of the letters. We were very explicit, and I can read to you the script that was used.

Mr. MANZULLO. Who is the "we"?

Mr. RAINES. Fannie Mae.

Mr. MANZULLO. What about the Coalition for Homeownership?

Mr. RAINES. We expressly said that the Coalition is sponsored by Fannie Mae. There is no deception of anyone.

Mr. MANZULLO. I just called your headquarters before I came here. I asked to speak to somebody from the Coalition of Homeownership, and no one had any idea what that organization was.

Mr. RAINES. Congressman, I am the Chairman of Fannie Mae. I am telling you we are the sponsor of the Coalition. You will be learning more about the Coalition as time goes on.

Mr. MANZULLO. I hope not the way that we did. I mean, did you contract with anybody to get commercial lists for this?

Mr. RAINES. Absolutely.

Mr. MANZULLO. With whom do you contract?

Mr. RAINES. I don't know the name of the contractor.

Mr. MANZULLO. How much did you spend?

Mr. RAINES. I don't know, Congressman.

Mr. MANZULLO. Could you give us that information before the day's end?

Mr. RAINES. I can get you that information, Congressman. But the implication you raise that there is anything wrong with a company seeking support and asking supporters to send letters to Congress.

Mr. MANZULLO. You contacted my constituents, and three of them expressly told you not to use their names and you did. And you are telling me there is nothing wrong with that?

Mr. RAINES. Congressman, I would be very happy to go and check to see any cases where anyone's name was used, unauthorized.

Mr. MANZULLO. I want you to send letters to 2,000 of my constituents apologizing for using their good name. This is bogus lobbying.

Mr. RAINES. Congressman, I reject that notion thoroughly.

Mr. MANZULLO. You don't have to reject it. You are not the one being lobbied; I am. These are my constituents.

Mr. RAINES. You are also being lobbied by our opponents, who also have letters coming to you.

Mr. MANZULLO. We got letters from no one else. No one else.

Mr. RAINES. You may be the only Member of the subcommittee then who did not get letters from anybody else.

Mr. MANZULLO. Did the Foundation play any role in this?

Mr. RAINES. Absolutely not. Absolutely not.

Mr. MANZULLO. So you see nothing wrong in using people's names without their permission?

Mr. RAINES. I do see something wrong with that. I say that in each and every one of these cases that I am aware of, we got their permission.

Now, that is not to say——

Mr. MANZULLO. I have 2,000 people in my congressional district and would like you to call every single one of them and get verification in writing that they authorized to you use their good name to lobby me on your behalf. Would you be willing to do that?

Mr. RAINES. We would be happy to go back——

Mr. MANZULLO. Every single one. And not at taxpayers' expense. At your own expense.

Mr. RAINES. Congressman, we would be happy to go back and contact each and every one of them to verify that they, in fact, have the position that they said over the telephone was their position. Each one of them was sent a copy of the letter that was sent to you. Each one of them has a copy of that letter. Each one of them was told exactly——

Mr. MANZULLO. There are people who sent letters from addresses that do not even live there. I don't know where you got your commercial lists.

Mr. RAINES. Maybe you have got a better list than we have got.

Mr. MANZULLO. I do not appreciate that.

What I do appreciate is this. I represent 700,000 people. They do not like to have their names used wrongly for the purpose of a bogus lobbying effort. And I reject those 2,000 letters. Most of them have no idea what is going on with this bill, and you used their good names to try to have some grass-roots effort, and I am telling you it is not working.

Chairman BAKER. Mr. Manzullo, your time has expired. We do have a vote pending.

I would like to give Mr. Raines any opportunity he would like to respond further.

Mr. RAINES. Well, my response is simply this. We will ask for support from people in the United States to support the secondary market. We will ask them to contact their Members to express their point of view. If any letter came to you that was not an accurate expression of the views of a constituent, I'm sorry for that, and we will endeavor in the future to ensure that that does not occur.

The thing I cannot——

Mr. MANZULLO. Then you are going to——

Mr. RAINES. Congressman, please, please, if I could just finish.

The thing we do reject is the idea that we can be attacked, that we can suffer these kinds of attacks and not call on support. You can reject the support; we do not say that you have to respond. But we do have a right to solicit people to come to our aid on a matter before the Congress, and that is what we have done.

Mr. MANZULLO. Then solicit it with integrity.

Mr. RAINES. And we tried to do that.

Mr. MANZULLO. Then you failed.

Mr. RAINES. That may be your view, Congressman. We believe we tried very hard to do this.

There is nothing secret about what we have done. We have been up-front in everything we have done, and we intend to continue to try to make our case in the best way we can.

Chairman BAKER. Mr. Raines, we do have a vote pending. I hate to ask your patience and long suffering. When we get back, Mr. Bentsen would be next up in the line of questions.

We will recess and try to return as quickly as possible. Thank you.

[Recess.]

Chairman BAKER. I would like to call our hearing back to order again, and ask everyone if they would please take seats, and we will reconvene. Thank you.

When we recessed, Mr. Bentsen, you were next up, so please proceed. Sorry.

Mr. BENTSEN. Thank you, Mr. Chairman. It has been very interesting. I have a number of questions. I do want to make a couple of observations as well.

First of all, I want to remind my colleagues, none of whom are here, but I want to remind my colleagues with respect to this issue of Fannie or Freddie mortgage-backed securities and/or debt becoming a new store of value or interest rate of record as the Federal debt goes down, Members should not be too alarmed by that.

Chairman Greenspan testified before the full committee earlier this year, and I raised the question with him as to what would become the new debt instrument that we would look at to peg interest rates off of if, in fact, we paid down the national debt over the next thirteen-or-so years, and he said there would be other issues in the market that would be found. And the mortgage-backed security market clearly is a somewhat more stable entity. So it shouldn't come as a great surprise, I think, to Members that this may be one factor. Whether or not that has a nefarious impact on the rest of the market I think is highly questionable.

I would ask both Mr. Raines and Mr. Brendsel if you could answer a few questions for me. One is, there has been a great deal

of discussion with respect to your debt about the leverage and capital ratios as compared to commercial bank debt and to securities, SEC capital ratio requirements, and even derivative arbitrage operations.

My personal feeling is that you were talking a little about by apples and oranges, but I would like you to address that and what quality of the security is with the debt issues.

Second of all, there is a concern about imminent demand on the part of the GSEs; thus, as long as we are able to issue debt at favorable rates, because of the implicit Federal guarantee, therefore, you have money in search of assets to invest in. What is your opinion of that?

Mr. Raines made one comment that he thought the upper end of the market would be $5 trillion, assuming that you acquired every mortgage loan that was outstanding, if you could elaborate on that. If you could give me a breakdown in your asset base of single family mortgages versus home equity lending and home improvement lending, to what extent does this non-traditional product make up the part of your asset base? And then if you would add to that the question, following up on what Chairman Raines said, regarding non-mortgage-related investments, what percentage of your assets are non-mortgage-related investments and how liquid are they? Do you have a liquidity test for that?

Mr. RAINES. Let me take a crack at it first. We do not believe there is an unlimited market for our debt. Our debt resides between Government and corporate, and we do not possess an unlimited market. Indeed, as we try to issue more debt, the cost of that debt goes up, and as the cost of that debt goes up, we cannot afford to buy mortgages. So we are constantly working all the time, trying to expand the market for our debt. It is bought on its merits, and the market understands the merits of our debt compared to other debt; and we have to work as an issuer very hard to find expanding sources of funds to invest in our debt. So we, like any other issuer, are limited by the appetite of investors.

In terms of the growth of Fannie Mae and its role in the marketplace, we have grown about 1 percent of market share a year over the last ten years. My goal is to grow another 1 percent a year over the next three-and-one-half years. Ultimately, we do not know what our share of the market will be, because we don't know how competitive other players in the market will be over time. Right now, for example, banks are very competitive, because the market has moved toward an adjustable rate mortgage market where they have the lion's share of that business. So in a given market, we may be more competitive or not competitive. So I have no idea what the ultimate position will be thirty, forty or fifty years from now, as the mortgage markets develop.

In terms of our non-traditional product, by far, thirty-year fixed rate mortgages is our largest product. But we have had second mortgages for many years. The percentage of those has gone up slightly in the last few years. We expect it to continue to rise slightly in coming years as second mortgages become more popular among homeowners who are seeking to improve their homes.

With relation to the liquid assets, I put up a chart earlier that showed that about 8 percent of our assets are liquid assets that are

held as our liquidity portfolio. We have an internal limit set by our board of directors of 15 percent of our assets. We have, in fact, drawn down our percentage of liquid assets since 1998, as the demand in the marketplace for us to be out buying mortgages increased. So we have reduced our liquidity portfolio from what had been its peak now down to 8 percent. That is all very liquid assets, typically AAA, short-term securities where we could go and sell today, get the cash, and use that for buying mortgages immediately. So that is a very, very small percentage of our base, but one that any financial firm is required to have in terms of liquid assets.

Mr. BRENDSEL. Let me take a crack at those three questions, Congressman. First, with regard to our debt, the size of its growth over time, the extent of its growth and so forth, we expect that the mortgage, talking about the total mortgage market in terms of mortgage debt outstanding, over the next few years our forecast is that total mortgage debt outstanding in the Nation, rising from the $5 trillion number, will grow in the neighborhood of 8 percent. Indeed it has been growing slightly higher than that within the last few years, but our anticipation is right around 8 percent.

I expect that Freddie Mac as a share of that or its own growth rate in terms of its holdings of mortgages, financed both by mortgage-backed securities and debt, will grow slightly more rapidly, maybe a couple of percentage points more. That would mean that, for example, as a percentage of total mortgage debt outstanding today, Freddie Mac is slightly smaller than Fannie Mae, we have about 17 percent of that share. We are likely to rise to 20 percent or so; in five years, 20 or 21 percent.

With regard to how the split occurs between mortgage-backed securities and debt financing, that depends on investor preferences and investor demand for the types of instruments they want to hold, it depends on, frankly, our success in developing a new international base for some of our securities, particularly for what we call our reference notes and bonds. I don't expect that——

Mr. BENTSEN. On that point quickly, this was raised earlier, the question of buying back MBSs for your account. Is that purely a pricing issue as to whether or not you hold the mortgages in your own portfolio backed by your corporate debt, versus buying the mortgage-backed security through the market?

Mr. BRENDSEL. Yes, while it strictly depends on the cost of financing once you take any differences in risks into account. Indeed, as we approach this, we approach it in the way that——

Mr. BENTSEN. The risk difference is an interest rate risk, it is not a credit quality risk, right?

Mr. BRENDSEL. That is correct.

Mr. BENTSEN. I think that wasn't made clear earlier.

Mr. BRENDSEL. Indeed, the way we manage our debt finance portfolio, there is only modest differences with regard to interest rate risk between that and a pass-through financing, and it is all taken into account in terms of how closely we match our assets and liabilities and, ultimately, the amount of capital that is held against that. Indeed, when you go to the risk-based capital rule as proposed in the 1992 legislation that is currently under development in a proposal by OFHEO, it carefully considers how that port-

folio will respond to changes in interest rates in the economy as with regard to credit risk, any change in credit risk as well.

As a result, the conclusion out of that is that we are highly capitalized, we are safe and sound, and as I said in my opening statement, the risk-based capital rules, as proposed by OFHEO, would subject us to a much more stringent capital standard to support both or all the risk of the business, including management operation risk, than that imposed on thrifts or, in fact, any other mortgage financial institution in the country.

With regard to home equity, second mortgage loans and so forth, we have, like Fannie Mae, purchased second mortgage loans for years, going way back at least to the early 1980's. I don't have the precise number in front of me. I would be willing to provide it to you, but I could say that it is less than 2 percent of our total mortgage portfolios, second mortgages, and home equity at the current time.

Finally, with regard to non-mortgage investments, there was some discussion about that earlier; we hold—any of our assets, I might say, must meet the dual test. One is, in support of mission and the purpose for which Freddie Mac is chartered, legally authorized, and second of course, obviously being approved by—that investment policy being approved by the board of directors. Currently, any non-mortgage investments as a percentage of our total mortgage portfolio, asset portfolio, is roughly 3 percent, and that is really held for purposes of liquidity and capital contingency to enable us to step into the mortgage market at any time.

To maybe give you an idea on the liquidity, we are constantly in the process of collecting cash flow, cash payments from our mortgage servicer and moving them on through to investors, investors in mortgage-backed securities as well as our debt. In any given month, that number that flows through may be $15 billion or $20 billion, and obviously that has to be invested, even on a short-term basis, in highly marketable, highly liquid securities, and that is one of the purposes of our liquidity portfolio, in addition to capital contingency.

Chairman BAKER. The gentleman's time has expired.

Next would be Mr. Toomey.

Mr. TOOMEY. Thank you, Mr. Chairman.

I had a series of questions for Mr. Raines, if I could. First let me thank the witnesses for joining us today. I guess I would like to discuss the issue of the implicit guarantee and specifically I guess I would start by asking, do you believe that there is an implicit guarantee of the financial performance of Fannie Mae on the part of the Federal Government?

Mr. RAINES. I don't believe that the Federal Government has entered into any such commitment to investors that there is a guarantee for investors of our debt. What investors expect is two things: one, that the Federal Government, having chartered us, will ensure that we are regulated in such a way that we will be able to meet our obligations in a timely way; two, they expect that we are such—having chartered us in the secondary mortgage market, that we are an important aspect of housing policy, and therefore, there will not be a matter of indifference to our continuing to operate in a safe and sound way. Therefore, we will continue to qualify to be

in that agency market between Governments and corporates. I think that is what people expect. I think that is what most people mean when they say implicit guarantee. I don't mean that people really think that someone can walk up to the United States Congress with one of our bonds and say please pay it.

Mr. TOOMEY. No, no. Do you share the view that the market believes that there is an implicit guarantee, that the market believes that the Federal Government would not let Fannie Mae fail to perform on its financial obligations?

Mr. RAINES. You just said two very different things. One is that there is a guarantee, and the other is that they would not permit us to fail to perform. I believe that the market believes the latter, that the Government would require us to perform and to be run in such a way as that we would perform in all but the most extreme circumstances.

Mr. TOOMEY. I am going a step further, saying I think that the market believes, in fact, that if all best efforts failed, the Federal Government would do whatever it took to make sure that investors, certainly at least in debt securities, were made whole, and I think that that is a rational conclusion that the market draws from a series of benefits that Fannie Mae derives from explicit policy.

If you look at things—you know, the fact that banks are permitted to invest unlimited amounts in GSEs, the authority to use the Federal Reserve Bank in ways that other institutions are not able to, exemption from State and local taxes, I mean there is a whole series of measures that treat the GSEs uniquely, and I think they go to this issue, and I think that the pricing of Fannie Mae debt clearly reflects that. I mean, Fannie Mae has a lower cost of funds than it could have without the implicit backing of the Federal Government.

Mr. RAINES. Actually, let me quibble with you a little bit on that, because if you look at the pricing of our debt and compare that to Treasury's, which is riskless, on our ten-year debt we pay 125 basis points more. On our thirty-day debt we pay 110 basis points more.

Mr. TOOMEY. I am not saying that they are exactly equal.

Mr. RAINES. But that is a lot. I mean, that is the market saying we see a big difference here in the matter of guaranteed debt.

Mr. TOOMEY. Here is the thing. The folks at S&P have publicly stated that if Congress moved in the direction of changing the relationship and changing that implicit backing, there would have to be a reassessment of the credit rating, and given the capitalization of Fannie Mae and the size of its balance sheet, that would make sense, and that would suggest higher cost of funds in that event. So the market is attributing of value and it is quantifiable.

My point is that I think, like any guarantee, there is a cost to that. The cost is not necessarily explicitly paid in cash, but there is a cost in the form of a risk transfer to taxpayers, and that is embedded in this guarantee.

So when we look at the activities of Fannie Mae, we have to ask ourselves, how is that cost being divided? It seems to me it is divided, in part, to the shareholders of Fannie Mae who have earned superior rates of return by just about any measure you could apply, and it also extends to lower mortgages. So there is a combination of the subsidy that comes from this implied guarantee. It goes in

a combination of ways to the shareholder and to lower cost mortgages. Do you accept that?

Mr. RAINES. Well, we believe we have demonstrated consistently over a number of years, that the entire benefit that we receive from our charter is passed on in lower costs to consumers, and it is not shared by our shareholders.

Indeed, Fannie Mae's financial performance is outstanding, but it is no more outstanding than other outstanding financial companies. There are other companies that have higher returns than we have and they certainly have higher stock prices and higher P/E ratios than we have. So a superior company can achieve the returns that we have achieved without partaking of the subsidy, as you described it, as part of that return.

We believe that it is clear, based on a request actually from the Chairman to OFHEO when he asked S&P to rate us, most recently S&P rated us AA-minus. There are only seven financial institutions in the United States who have a AA-minus rating, so we are one of the top-rated companies, putting aside any kind of Government backing that we may have, and we believe our financial returns have more to do with our risk management capability than with the subsidy.

Mr. TOOMEY. I fully acknowledge the quality of the risk management of Fannie Mae; it is well-known. But CBO certainly thinks that part of the taxpayer subsidy goes to the benefit of shareholders, and if you look at the consistent well-above-market-returns that Fannie Mae has generated over time, when compared to anything resembling a peer group, I think it is hard to attribute all of that superior return to just being more sophisticated and better at managing risk.

Anyway, my point is that—and we may disagree on this, but it strikes me that the evidence is pretty strong anyway—that this subsidy that comes from the taxpayer goes both to lowering mortgage rates and to generating better rates of return. For instance, in the absence of the implicit guarantee, it seems to me quite likely that Fannie Mae would be compelled to raise equity capital in the marketplace to—you know, if you played out a scenario in which there was no Government involvement.

Chairman BAKER. You have exhausted all of your time, Mr. Toomey, if you could wrap it up.

Mr. TOOMEY. I will wrap it up.

My point being, that I think this issue of how this cost is shared between the mortgage, lower mortgage cost and shareholders, is one that obliges Congress to look very closely into expansion in the new areas of activity which could actually increase the cost to the taxpayer, while not necessarily, or at least not proportionately, benefiting the cost of home ownership.

Mr. RAINES. Mr. Chairman, if I could just respond quickly. I agree with you that that is a legitimate question that this subcommittee has to look at consistently. In 1992, this subcommittee and Congress did look at that and came to the conclusion that they needed to make adjustments, and they made those adjustments, by increasing our obligations in terms of our affordable housing goals, and also increasing the capital requirements placed upon us.

In terms of whether Fannie Mae could operate successfully as a business in the absence of its charter, I think the answer is simply a resounding yes. We are rated AA-minus without the charter. The only difference you would have is that the benefits we now pass on to consumers, they wouldn't get, because we wouldn't have them to pass on to them, but Fannie Mae would be a successful company with or without the charter.

The last point I would simply make is on the CBO subsidy estimates. If you take the CBO subsidy estimates and correct them simply for errors that they made in the calculation of the estimates, you move from us receiving any of the benefits, according to their terms, to us having a net payout of benefits of $3 billion. Remember, even CBO said two-thirds of the benefits passed on. So we are only talking about the $2.1 billion that is in doubt. If you correct that for errors, in fact, using CBO's methodology, you would see that all of the benefit is, in fact, passed on to the marketplace.

Chairman BAKER. Mr. Brendsel, did you want to respond?

Mr. BRENDSEL. I am not certain whether to enter into this discussion or not. It is the age-old question about the implied guarantee, and so let me just summarize my view this way with regard to part of this question.

One is benefit to homeowners versus the benefit we enjoy in the capital markets. I don't think there is any doubt but that we are able to finance ourselves in a way, access to the capital markets, size, liquidity, rate, albeit a much higher rate than paid by the Treasury or whatever, than what we would otherwise be able to do were we not a very special company chartered by the United States Government.

The question then is whether or not the homeowners benefit exceeds or is smaller than this capital-raising capability. I think the CBO numbers, which goes back to the 1996 hearing around this, my view is more discredited. I think Chairman Raines shed some light on that. And second, beyond that, there are benefits to home buyers that don't get simply measured by that.

Indeed, a different way of looking at this, asking the question, is what would happen if Freddie Mac and Fannie Mae weren't there as Government-chartered corporations? All you have to do is look to other parts of the market, look to the subprime market, look to predatorial lending and so forth, where Freddie Mac and Fannie Mae aren't today directly involved, and you can start to see a vision and a picture for what the mortgage markets, what the housing finance system at least might be like or trend to.

So we bring competition, we bring small lenders, we bring a whole host of things into the marketplace, into the local communities, that aren't directly captured by simply measuring a difference in currently jumbo rates, or whatever it is, and conventional mortgage rates, which is in the way of how some of these calculations are done.

The final point I would make is that, the fundamental question, are we a risk to the taxpayers? Our securities aren't guaranteed, but are we still a risk to the taxpayers, because of whatever obligations might occur in the future that frankly the Nation, Congress, feels that they might have? The 1992 legislation clearly put in place an approach to regulation, an approach to capitalization that

says these companies, chartered for a special public purpose, we expect to remain safe and sound, and they put in place an approach to capital regulation and regulation in general that would do everything possible to make certain that they would remain safe and sound, as judged by the Government, without at the same time imposing unnecessary costs on home buyers and renters.

Chairman BAKER. If I may suggest as to process, we still have four Members who have yet to be recognized the first time, and there are some Members who are indicating a desire to ask a second set of questions. So to the extent—I want to facilitate your appearance—that your remarks can be targeted for the remaining discussion, it would be helpful to everyone.

Mr. Mascara.

Mr. MASCARA. Thank you, Mr. Chairman. I would ask permission to enter an opening statement into the record.

Chairman BAKER. Without objection.

[The prepared statement of Hon. Frank R. Mascara can be found on page 209 in the appendix.]

Mr. MASCARA. While I don't profess to be an expert on Fannie Mae or Freddie Mac, I do want to compliment you for doing a great job, and that might be part of your problem. I will get to that later.

While I do not want to diminish the importance of these hearings, I congratulate the Chairman and Ranking Member Kanjorski for holding them, I do question the genesis of H.R. 3703, GSA reform. I understand you are not perfect and you don't claim to be perfect about what you do, but in earlier testimony and questions, I think we got past the issue of solvency, and I am satisfied with your response, Mr. Raines, to the earlier questions regarding that matter.

But I took some notes, and my notes said you create no debt, you have equity in the loans you purchase, you carry some form of insurance, the full faith and credit of the United States is not issued in this case; there is no risk of insolvency. In fact, you would probably be the last to go if everything went. You are rated double-A, is it? Minus 2, whatever that means, it must be good. And the obligations you have are solely the responsibility of Fannie Mae and Freddie Mac. You invest in high liquid assets. If a bank or thrift finances a mortgage, the paper which it is financed through, Fannie Mae, Freddie Mac, replaces short-term debt for the banks with long-term debt by Fannie Mae. I mean, it goes on and on.

What I am asking is, and I don't want to put you on the spot, but could it be possible that you are performing too well and that the banks and thrifts that you serve feel that you are encroaching upon their domain somehow?

I ask this question, because in earlier testimony, you talked about the Internet and the use of the Internet, and to either Chairman Brendsel or Mr. Raines, one of you or both of you recently partnered with Microsoft to provide on-line services which could even further speed the process, and it would appear that these technological developments blurred the distinction between loan origination and secondary mortgage market. What assurances can you provide this subcommittee that these activities remain within your mission and do not pose a threat to the market for loan origination?

I would like to cut to the chase. There is something wrong here that I must be missing. What you do, you do well; you are sound, you are serving a lot of people in this country who want to own a home and couldn't own a home if you weren't available to them. Is that part of the problem? Is technology a part of the problem?

Mr. BRENDSEL. Congressman, you brought up Home Advisors and Microsoft, and that is a venture, a partnership by Freddie Mac. Freddie Mac has always been at the forefront of innovation, exploring new frontiers; how to use technology to link up with our customers, with mortgage lenders, and in this case, Home Advisor, which is a newly created company involving several manager mortgage lenders as investors, and Microsoft. But a separate company uses Freddie Mac's technology for automated underwriting, underwriting mortgage loans, combined with the Internet, to allow lenders that are on that site to be able to originate a mortgage loan and sell it into the secondary market using the latest technology and using the efficiencies of the Internet.

Indeed, we are not permitted by charter to originate, to close a mortgage loan and, indeed, we are not in this venture, and I will be happy to provide, in fact, a letter that I recently wrote to Congressman Royce regarding this particular venture, since I am very excited about it. Indeed, I think it is one of many ways that we can use technology and the Internet to make the mortgage lending process and the financing process more efficient.

Mr. MASCARA. Thank you.

Chairman BAKER. Mr. Raines.

Mr. RAINES. We are not involved in the Microsoft venture. But going to your core question, I believe there are—putting aside this particular bill, because I believe that the Chairman's interest in this bill stems from his interest in systemic risk. So putting that aside, there are people who criticize us because they believe that we will, in fact, bring the benefits of the secondary market to the underperforming parts of the mortgage market in which they have been operating. When they look at that they say, what are we going to do? We have been charging higher points, higher interest rates and giving worse service. And Fannie Mae is now going to bring a system that has worked well for middle class America, worked well for moderate income America, they are now going to bring that to lower income America, and they see that as a challenge and they would prefer not to have that challenge.

So they have banded together, as in the old Washington tradition, to come to Congress and to go to the Administration, go to our regulators and say, please slow them down, stop them, do something to keep them from bringing this market to customers that they have traditionally served.

Now, we only can go anywhere with lenders, so it is an ironic debate. It is really a debate amongst lenders in which one set of lenders is saying, don't let these other lenders in, because they think these other lenders are going to bring Freddie Mac and Fannie Mae with them. But neither of us can originate a loan, we can only go where lenders want to go; we can only innovate loans that lenders want to offer.

So there is an aspect of competition. But I am sure that you as a Member of Congress and the other Members, this is not new, this

is not the first industry in which people wanted to bring competition to Capitol Hill rather than do it out in the marketplace.

We prefer to do it in the marketplace. If others have a better product, they will win. If they don't have a better product, why should they win?

Mr. MASCARA. That is a good response, Mr. Raines.

Chairman BAKER. Your time has expired, Mr. Mascara.

Mr. MASCARA. I thank you, Mr. Chairman. You are doing a good job.

Chairman BAKER. Did you mean me or Mr. Raines?

Mr. MASCARA. Certainly, the Chairman also.

Chairman BAKER. I was just getting a clarification here.

I would point out that the Members on the Democrat side all have been recognized at least once to speak. There are a couple of Members on the Republican side who have not yet been recognized, so we will do those back to back.

Mrs. Biggert.

Mrs. BIGGERT. Thank you, Mr. Chairman.

Before I begin my question, I would just like to say that many of the local banks and thrifts which originate mortgages in my district belong to the Federal Home Loan Bank of Chicago. Alex Pollock, the President of the Chicago Home Loan Bank, has provided a written statement for today's hearing, so I would ask unanimous consent to submit Mr. Pollock's testimony into the record on his behalf.

Chairman BAKER. I am sorry, I was diverted in my attention. Could I ask you to restate? I will give you your time back.

Mrs. BIGGERT. Since there are many local banks and thrifts in my district which belong to the Federal Home Loan Bank of Chicago, and the CEO and President, Mr. Alex Pollock, has provided a written statement or testimony for today's hearing, and I would ask unanimous consent to submit his testimony.

Chairman BAKER. Absolutely. Without objection.

[The information can be found on page 339 in the appendix.]

Mrs. BIGGERT. Thank you. Based on that, in his testimony, when you get to the end, most every question has been asked, so I would ask your indulgence.

In his testimony, Mr. Pollock suggested that the focus of this legislation should be to encourage competition among the three GSEs that are here by leveling their regulatory playing field for the GSEs to the greatest extent possible. He suggested that the more competitive and efficient secondary mortgage market will benefit both community mortgage lenders and the American home buyers.

So I would like to ask the witnesses if they agree with this suggestion that by encouraging GSEs to compete against one another, the consumer would benefit greatly?

Mr. BRENDSEL. Absolutely. We already compete against each other. With regard to—an additional comment about the Federal Home Loan Banks. I would only say that I think, as Mr. Hage has said to start out with, the Federal Home Loan Banks have a somewhat different mission, have a somewhat different purpose, have a different capital structure and capital standards. So we are kind of comparing apples to oranges in regard to the nature of the institutions.

But certainly in the secondary market, I can guarantee you today and in the future, Freddie Mac and Fannie Mae will be very intense competitors, which is to the benefit of America's home buyers.

Mr. RAINES. Indeed, it was a brilliant stroke to have created both Fannie Mae and Freddie Mac, because we have been very competitive over the years. But let me say a word about the Home Loan Banks. The Home Loan Banks and their traditional role of making advances have a unique role. It is the GSE for banks and it helps them obtain the funding they need to manage their businesses.

The Chicago Bank, and Mr. Pollock in particular, has been leading an effort to try to expand the range of the Home Loan Banks into actually owning assets, owning mortgages in particular, and to become an active participant in the secondary market. We take no position on whether or not that is good policy or bad policy, but we think it does raise a number of issues that are not addressed in the bill before you.

There are issues of capital, whether or not the risk-based capital standards that Fannie Mae and Freddie Mac have to live with in the secondary market will apply to them. Issues of taxation—as Chairman Leach said, we pay Federal income taxes, they do not. There are issues of housing goals; if you are going to be in the secondary market, do the housing goals, percentage of business housing goals, apply to you as they apply to Fannie Mae and to Freddie Mac? And in terms of the nature of your capital, do you have to have permanent equity that is not refundable, not callable, not in any way temporary, but permanent equity owned by entities that are not using insured deposits to pay for?

I mean, those are big differences. So that if the Home Loan Banks would like to become a bigger competitor in the secondary market, we think there are a whole range of issues that the bill doesn't deal with as to will they have the same structure that has worked so well for Fannie Mae and Freddie Mac in doing that.

Mrs. BIGGERT. No comment?

Mr. HAGE. A lot has been said and a lot has been well intended. The change that is underway at the Federal Home Loan Bank system challenges us all to find the appropriate way for us to respond to our mission. Our mission hasn't changed; it is to be a provider of funding for home mortgages. The notions of purchasing assets has some merit, but it does have many of the considerations that have been already mentioned in terms of capital implication, and risk management implication.

Mrs. BIGGERT. Thank you.

Chairman BAKER. Thank you, Mrs. Biggert.

Dr. Paul.

Dr. PAUL. Thank you, Mr. Chairman.

Before I ask my question, I did want to relate to Mr. Raines that our office, too, has some experience in calling some of our constituents, and some of them did volunteer the term "Fannie Mae Foundation" that they were approached by, and whatever that means, I don't know, but they definitely did volunteer that term.

In my opening statement I mentioned that I was interested in what the Government Sponsored Enterprises do in relationship to monetary policy. Last year, when the Y2K crisis was approaching,

the Fed took it upon themselves to be prepared, nevertheless, by increasing credit significantly. Since there were not enough Treasury bills available, the Fed started purchasing the Government agency securities, and they had a large number of these. They started in October and they said they would do this for a period of six months.

After the first of the year occurred and there was no crisis, they sold a lot of these, but they maintain a significant amount, $25 to $30 billion worth, and they then canceled the program in April like they had initially indicated.

To me, this may or may not have some significance, but you are concerned about losing an $8.5 billion line of credit which you have never had to use, and at the same time, it looks like the Fed is accommodating support; I mean the Fed is a lot stronger lender of last resort than anybody, since they can create the money out of thin air, endlessly. So it seems to me that the stage is set for maybe losing the line of credit and you relying on the Federal Reserve to take care of any potential problems. That certainly came about with a foreign company. Long-Term Capital Management happened to be a foreign company. They came to the rescue there in a hurry to make sure that there were no problems. So I see no reason why the Fed wouldn't come to the rescue.

My question is, are you ever involved in discussions with the Fed? Did you know this was coming about? Does this have any significance? Do you expect the Fed to provide the credit necessary if there were problems in the marketplace? It seems like this is every bit as significant as the line of credit to the Treasury, and maybe even more so. Could you comment?

Mr. RAINES. Well, let me make a couple of comments. First, my understanding is the Fed activity at the end of last year was to make eligible for repurchase agreements, mortgage-backed securities as collateral for a bank to take to the Fed as collateral for the advances from the Fed. Not that they were buying mortgage-backed securities, but that this was an eligible collateral.

Dr. PAUL. That becomes an asset of the Fed; that is listed as an asset.

Mr. RAINES. Yes, if they were to buy it. I don't know if anyone actually did repos with the Fed, using that collateral, but that is what they did. It wasn't that they were expanding their own purchases. They had a program of expanding the use of that collateral as one of the things that people can use.

Second, I think Chairman Greenspan in a recent speech made very clear what he viewed the role of the Fed with regard to financial institutions that may get into financial difficulties is, and that was to worry about systemic risk and not about the fortunes of an individual entity. I think that is right. I think that the focus should be on maintaining liquidity in the marketplace. Indeed, our risk management techniques depend on the Fed doing its job in maintaining liquidity. And one of the reasons that we invest in such highly liquid assets is to benefit from the market's perception of liquidity. So we are quite comfortable with the Fed's position that if they maintain liquidity in the marketplace, that well-financed companies like Fannie Mae will indeed benefit from that type of a Fed role.

Dr. PAUL. But let me suggest again that the Fed actually holds these securities as assets. Don't you think this would provide a service for you, other than in the broad sense of just increasing credit? I mean the actual purchase of these assets? They are capable of doing it; it is legal for them to do it. There is no law that says they can't. So it seems to me that you have the protection that you need, and the line of credit of the $8.5 billion doesn't have as much meaning.

Mr. RAINES. The Fed has the discretion to buy a variety of assets to carry out their activities. They look for high quality, highly liquid dollar denominated assets. Ours are our debt, and our MBS would fit that category. But they, in their discretion, would decide how to operate in that realm, and I would not want to give the Chairman any advice as to how to do that.

Chairman BAKER. Thank you, Dr. Paul.

Mr. Royce.

Mr. ROYCE. Thank you, Mr. Chairman. I think there is a little bit of an irony here when we look at the underlying bill that we are speaking to, H.R. 3703. It seems to do very little to manage or restrict the expanding risks of the Federal Home Loan Bank system. And I just wanted to ask Mr. Hage a few questions about that, because the Federal Home Loan Finance Board is pushing regulatory changes that would drive your system to participate more heavily in the Chicago mortgage partnership finance program. This program started as a $750 million pilot. It is now touted by the Chairman of the Federal Housing Finance Board as "the future of the system," in his words. You might know that I have expressed concern over the past few years over the Chicago mortgage partnership finance program.

I believe the so-called Chicago pilot goes beyond the mission of your Federal Home Loan Bank system. I think it significantly increases the risk, both credit and interest rate risk. I am concerned that it takes the system too far away from the traditional advances business and too close to basically managing a portfolio. I am further concerned that the program is now actively purchasing FHA loans expressly guaranteed by the Federal Government. Finally, I am extremely concerned that the capital requirements of the system are significantly lacking.

I don't know how much retained earnings or core capital the system has beyond what members must hold for membership in borrowing. I am sure you could tell me that. I would like to know the new risk-based capital standard in Graham-Leach-Bliley. Does that mirror the risk-based capital standard maintained by Fannie Mae and Freddie Mac? That would be my second question. Third, does the Federal Home Loan bank system have a ten-year stress test that measures extreme swings in interest rate and extreme credit losses? That would be my third question of you.

Mr. HAGE. Congressman Royce, those questions are not answered today because the capital regulations are still being formed and presented for final rulemaking. There certainly is concern that the addition of member-purchased assets does change the risk profile of the traditional balance sheet of the Federal Home Loan Bank system, and it is my understanding that that risk is being assessed and weighed as the capital regulations are being formulated today.

Many of our members have concern about that risk profile and whether that is an appropriate risk and how we are going to manage it, because our underlying concern is that the system remain strong and safe and sound in any environment that it is in.

Clearly, the membership of the Home Loan Bank system still views the advances as the traditional product that it looks to get from the Home Loan Bank system, and that product does allow us to provide credit to housing finance and economic finance in our communities.

Mr. ROYCE. Well, that is reassuring, but apparently there is a conflict division here, because as the Chairman of the Federal Housing Finance Board, he says no, the Chicago program is the future of the system. So I am reassured that your board members view that differently, but it does highlight, I think, a little conflict in debate here.

Mr. HAGE. As I said, the debate is still emerging.

Mr. ROYCE. OK. Well, my other question would be to Mr. Raines. I think that Chairman Baker is appropriately focused on the risk to the American taxpayer and I would like to explore this area with you a little further.

At least for banks and thrifts, we have all learned a very tough lesson, that the American taxpayer can be called upon to provide a backstop to the Federal Government. And I can assure you that I would be the strongest opponent to any taxpayer bailout of Fannie Mae or Freddie Mac, and I am rather convinced that the debt obligations and securities of these companies expressly state that there is no backing. We in Congress have made that law. But as Mr. Baker stated, I want to make sure that there is no such risk.

So perhaps if you could walk us through how a home mortgage becomes risky, what credit and interest rate protections are there in statute, in regulation, or in your business practice, that stands between the GSEs and the American taxpayer. Perhaps the way you could do this so that we could follow it would be if you took us through the process that occurs when a mortgage goes into foreclosure. What does it mean to the bank; what does it mean to the GSE; what does it mean to the investor? I think that would be helpful.

Mr. RAINES. Sure. I would be delighted to walk you through that.

The key elements in managing the risk in our business are two things; one is the credit risk and the other is interest rate risk. Let me say something about the credit risk, which was the example that you were giving.

When we measure the credit risk of an asset, we first start with underwriting. What are the terms under which we will buy a loan, and what must be the terms that the lender uses in making the loan? What are the criteria for down payment, for credit, for the collateral that we have backing up the loan, what kind of appraisal requirements? So underwriting is a key way that we begin in implementing the process.

Then we look at the issue of who is going to bear which risk, and we are big believers in risk-sharing. We believe that in order to manage the large level of credit risk we have, we can't simply take

all of that risk on to ourselves and believe we can put a price on that; we have to share that risk.

What this chart shows you, for example, on our book of business, $1.2 trillion, how much credit loss protection there is, even before our capital is involved. What you can see here is that we have over $740 billion of borrower equity protecting us in the event that a loan were to go bad. On the average loan that we have outstanding, it is about 40 percent of the value of the home is in equity. So if a loan were to go bad and we were unable to help the consumer stay in the home—which, by the way, we are able to do that in 50 percent of the cases, because people don't just stop paying their loan because they want to stop paying, they stop paying because they got sick, divorced or lost their job. So 50 percent of the cases we work out. And the other 50 percent, you look to the equity, you acquire the loan and you sell it. If there is sufficient equity in the home, then you pay off the loan. If there is not sufficient equity in the home, the second place you would look for a loan that had a lower-than-normal down payment, lower than 20 percent, would be mortgage insurance. So the mortgage insurance industry essentially exists solely for the purpose of insuring investors like Fannie Mae and Freddie Mac against defaults. These entities are rated AA or AAA, and we would second look to them and look to mortgage insurance to help people, whatever the loss would be.

The third place we would look would be to recourse from the lender. This might have been a transaction in which the lender kept some of the credit risk in a negotiation with us, so we would look to them. That is another $30 billion.

So we have $838 billion standing, before any losses would occur at Fannie Mae. And that is the reason that you can see, on a very large book of business, in excess of $1 trillion, our average credit losses over the last ten years was $285 million. Last year it was $124 million against capital of $19 billion.

So our credit losses are a fraction of those of other financial institutions, and they are a fraction of it because we start with a great asset and we do an enormous amount of risk-sharing. We, unlike most depository institutions, don't say we will take the entire risk and we will manage it all. We say we want to find risk-sharing partners with us.

I don't have the equivalent chart on interest rate risk, but I could give you exactly the same scenario on interest rate risk. We buy loans and we match their funding, but, because there is this option for the homeowner to give the loan back to you when it is in their interests, when it is probably not in your interests, when rates have dropped, we try to match that potential cash flow. We don't just guess what they will do, we sell debt that has the same option.

So if the homeowner has an option to give us back the loan, we have an option to give back the debt. If the homeowner decides to keep the loan, we have the option to keep the debt. So we engage in risk-sharing there. That is why I said in my testimony, we spend $6.4 billion a year to buy risk-sharing with other players. We spend over $4 billion to buy that for interest rate risk, and we spend over $1 billion to buy that for credit risk.

So this whole risk-sharing structure that has been put in place is the major protection for our capital. So you would have to go

through all of this, through all of our protection on interest rates before you touch our capital.

That is why Fannie Mae and Freddie Mac can withstand the ten-year stress test as rigorously as we have and why other entities can't. Because if you ask them, what is the stress test you use, they will say well, we assume interest rates might move 100 basis points or we assume that our losses might double. Whereas we are facing what at least one analyst referred to as the nuclear winter stress test. I mean if all of those things really happened, it would be an unusual world, but it would be the case that Fannie Mae and Freddie Mac would still be there, and all of the people who have been criticizing us as being undercapitalized would be out of business.

Chairman BAKER. Mr. Royce, you have well exceeded your time, and he may have expired you as well. I don't know.

For Members wanting to ask a second round of questions, we will start those now, and I would start.

To clarify for the record, Mr. Raines, I am sorry Mr. Mascara has departed, the genesis of H.R. 3703 is modestly, after some years of concern, an expression on the subject going back to the day of prior CBO reports to this subcommittee in 1996 that I requested relative to systemic risk issues. Again to say that this is not a criticism of anyone at Fannie Mae or Freddie Mac or Home Loan Bank today, but we have an obligation to perform regular and routine maintenance. If this were an airplane, you would not want to wait until the engine went out to ask the question, what is our maintenance schedule? I think while you are high-flying and doing well, that is the time when you spend a little resources on worrying about adverse circumstance.

To that end, when an institution is as large as any of the institutions represented at this table, in your case, the third largest asset-sized corporation in America, the potential for that organization to have financial difficulty and, thereby, harm innocent third parties is quite obvious, and the Fed, in many cases, has interceded to preclude those adverse economic circumstances from having that ripple effect in the economy.

I believe it is our mission to provide market discipline through enhanced transparency, so people do understand the business plan and understand the true risk they are assuming when they either buy a security or take an equity position. The trouble is that in marketing securities, and I am not saying that you market it this way, I am just saying this is information provided to me about how securities may be marketed, prospective investors are told that members of the board are appointed by the President, the Fed exempts agency securities, including mortgage backs—accepts, rather, securities, including mortgage backs as collateral; that there is no limit on the amount of holdings that a bank may have of GSE debt, which, in fact, there are 4,003 banks today which have between 100 and 500 percent of total capital invested in GSE securities; that you are regulated by HUD and that you are subject to OFHEO's stress test, which of course is almost there. The marketing approach would skew market discipline, because it tells the prospective investor, don't look at the underlying business fundamentals necessarily.

Now, of course, any analyst is going to do that, but I didn't turn to Moody's rating, to which you made reference. Moody's said its ratings reflect good financial fundamentals; granted, the strong implied Government support of the Government Sponsored Enterprises and the competitive advantages they enjoy as a result of their special status.

Now, I take that to mean that a respected rating service is saying, you are priced where you are because you are good, number one; and two, because of the implicit guarantee.

That is exactly the point which I have been trying to make for some time. I think we are performing an excellent opportunity in the secondary market by standardizing mortgages. I think the underwriting criteria are excellent. I think it facilitates home ownership. It is my role, however, I think appropriately, to ensure that the market is not having its vision of the underlying business fundamentals totally skewed by the belief that there is an implied guarantee; therefore, no risk.

It is clear Chairman Greenspan, in recent remarks, has said many are operating on the basic assumption that there are large financial institutions in this country—and I think he chose those words very carefully—not to say banks, that are being viewed as above all risk in the market because of the implied guarantee, and that is a false assumption.

So can you work with us here?

What I am getting back from Fannie Mae is that there is not one thing that we could suggest that we alter with this legislation that is worthwhile to pursue. In fact, it has been described as sand in the gears of a well-oiled machine. I just want to make sure I know where the machine is going and whose collateral it is going to take to make sure it runs at double digit return for the next generation. There has to be some way to get our arms around the enormous growth, the simple rate of return and, frankly, the lack of a safety and soundness regulator being functional.

You and I have had conversations where I think you have indicated to me that you would like to see a strong functional regulator, because it would help you marketing your product in the secondary market. Can we at least start there? Can you respond?

Mr. RAINES. Well, Mr. Chairman, I think those are very helpful comments, and I hope I said properly, in answer to Mr. Mascara's question, that I believe that your interest in this legislation stems from the issue of systemic risk. I hope I have made that clear.

Chairman BAKER. Absolutely, yes, sir.

Mr. RAINES. I have no doubt in my mind that that is what your interest is.

Chairman BAKER. At best, arm's length, but further than that, as far as I am concerned, with any other economic group trying to press any other advantage within the Congress, and I would tell all Members that. The provisions of this bill have been out and about for a long time and I shared them with all of the principals before the bill was introduced, so there has been no effort to take anybody by surprise.

Mr. RAINES. Right. But just a couple of points. On your last point, we do not say that the system that we have now is absolutely perfect and no one could conceivably think of any change

that would make it better. Indeed, when you invited me to review your bill, I did so with the thought that we would be involved in a discussion. But for, I am sure, good and sufficient reasons, you introduced your bill and went forward on the bill, so we have not had further discussions of what might be changes that could be made, not driven by one particular bill. Our comments so far have gone to the bill as introduced as opposed to the issue of is there anything that could make the system better.

So I don't rule out that there are things that could make the system better, and I would be delighted to talk to you about things that deal with issues of systemic risk that might make the system better and could relieve concerns that you may have.

In terms of the marketing, I just came back last week from Europe, in which I had the opportunity to meet with a number of our debt investors, and a couple of things became very clear. They clearly understand that our debt is not guaranteed. Indeed, some of them resent the idea that smart institutional investors are operating under a total misapprehension about billions of dollars that they have invested of their investors' funds, so they are very clear on that question.

They also, though, are very clear that there is something called this agency market that is somewhere between the Government and ordinary corporations, and they know that there are certain indicia that go with that and they look for those indicia, because they believe that what that says is that these are entities carrying out an important public purpose and that they will be closely regulated from a financial standpoint, and therefore, they are not easily dispensable. The Government will not simply look and go, well, it is gone and we don't care, which it might very well do with an individual bank or an individual S&L.

So they are looking for the Government to protect its own interests in the public policies that we advance by ensuring that we are safe and sound. That matters to them. It doesn't make us guaranteed by the Federal Government, because they charge us dramatically more than they charge the Treasury, but it does make us a better investment than if we were an ordinary corporation not pursuing a matter of public importance.

Chairman BAKER. Well, if you took out the name Fannie or Freddie and the "security," and you put almost any other name in America in that slot, and then said there are 53 banks in the country today, this morning, that have 500 percent of their total capital invested in GSE securities. Now, I have always operated on the premise that concentration in a single line, in a geographic area—the great lesson I learned from the S&L problems of the 1980's, coming from Louisiana and the oil and gas turmoil, was that diversification, geographic and business line, was extraordinarily important to management of risk.

When we have institutions at this level of concentration, which no other corporation enjoys that exemption from that level of concentration, isn't that some small measure—I guess you dispute Under Secretary Gensler's remarks in that area as well?

Mr. RAINES. Well, let's just go to the facts. I think the factual description is just inaccurate in this case.

There are two limitations that banks have, a 10 percent limitation on investments in securities and a 15 percent limitation on loans. It only applies issuer by issuer or borrower by borrower. It doesn't apply to a class. So there is no class of GSEs that is limited for banks, just as there is no class of oil companies or no class of department stores. So it is an individual-by-individual issue.

If you look at Fannie Mae holdings, the average holding of Fannie Mae securities by banks is only 15 percent. If you look at the banks who hold 100 percent or more of their capital in Fannie Mae, they represent 1.28 percent of total bank assets. They are little banks. If you look at the 20 percent of the banks that hold two-thirds of the assets in the system, they hold less than 10 percent. They all would qualify under the rule as currently established.

So from a systemic risk situation or circumstance, it is the big banks you worry about. They don't hold excessive amounts of Fannie Mae debt.

Chairman BAKER. But 41 percent of all banks have 100 percent of capital in GSE securities. I mean it can't be dismissed so simply, because——

Mr. RAINES. But the rule doesn't apply to GSE securities. It applies to Fannie Mae securities, to Freddie Mac securities, to General Motors securities.

Chairman BAKER. I understand, I understand.

Mr. RAINES. If you look at it issuer by issuer, what you find is relatively few banks—there are 725 banks that hold more than 100 percent of their capital in Fannie Mae, and that is only 8 percent of all banks and they represent 2.1 percent of bank assets.

Chairman BAKER. Well, your point is well made and I understand your point, but once you get past Fannie and Freddie and you go to the list of the GSE securities that are available beyond your two organizations, my level of concern only goes up incrementally. You are well-run and well capitalized, and I have no concern about business risks with you, but the further you go out on that GSE limb, the weaker it gets. Somewhere I am looking for something we can agree on where we might be able to communicate that there are points that are worth pursuit.

I have far exceeded my time.

Mr. RAINES. Mr. Chairman, I think you have just put your finger on one that we can sit down and talk about. We believe that in the legislation passed in 1992 you set up a state-of-the-art capital requirement on Fannie Mae and Freddie Mac, and it is very tough. We believe that similar requirements being applied to all of the GSEs would be a step forward. We believe that if others can survive the same stress test that we can survive, it would give you a lot of assurance on just the issue you pointed to, and we would be delighted to work with you on how can you get that same level of insurance that all of the GSEs can survive that same kind of very difficult stress test that Fannie Mae and Freddie Mac are going to be required to survive.

Chairman BAKER. I just wish we had it in effect now.

Mrs. Jones, you are next.

Mrs. JONES. You wore me out, Mr. Chairman. I don't have any more questions.

Chairman BAKER. I don't believe it. Ms. Waters does, though.

Ms. WATERS. Mr. Chairman, I apologize if this has been discussed already.

I was concerned about the requirement in the legislation for HUD to have to approve new products. I don't understand the reason for that, and I don't understand what obstacles would be placed in the way of implementing new products that may be very meaningful and cost-effective and good for the consumer.

So let me just ask both Mr. Raines and Mr. Brendsel about this requirement in the bill.

Do you think it is a good idea for HUD to be further involved with the GSEs, particularly as it relates to the oversight and the concurrence and new products? And if they are, how could that help you or hurt you?

Mr. BRENDSEL. Frankly, I think it is a bad idea. It would stifle innovation and, frankly, just add to costs. We respond to our customers, our lenders, and occasionally we come up with a new idea ourselves along the way. Regardless, it would require, particularly in terms of introducing this to the market, it would require endless delay, add to the cost; and ultimately, who would want to work with a company like Freddie Mac to bring a new mortgage program to the marketplace if they had to go through a lengthy delay of three months, six months or whatever as a result of this entire mortgage or new product approval process?

All of the products, all of the programs that we do must meet the test of being consistent with our charter, and today, under the current legislation, if there is a significant new activity, a new program, frankly it already must meet that regulatory requirement of being approved by the Department of Housing and Urban Development, as our mission regulators. So this particular provision would just go way beyond that and add a bureaucracy that frankly would not achieve, I think, the intended purpose, which is really to make certain that we have very strong, safe and sound regulation, an independent regulator. It would not enhance that regulatory structure at all.

Ms. WATERS. Mr. Raines.

Mr. RAINES. I agree with that. In the 1992 legislation there was put in place a program approval process where if we were to begin a brand-new program of activities, we had to go to HUD to get approval. And the authors of that provision were very clear that it was not to get into the level of products and processes which would burden the companies and keep them from innovating. As we read the draft of the legislation at this point, it says that any new process that we enter into with a lender would require approval by HUD.

So that means—for example, we have been working with Mrs. Maloney for a while now on co-op loans, which has always been hard to get into the secondary market, and we have tried a variety of different loans to see what will work. That would have meant every time we did that, we would have to go to HUD and say approve this, approve that. If we had a lender who said I have a new way of servicing loans that I think will make a difference in terms of the value of this loan to you, we would have to ask HUD to approve that.

So as written now, it is the most extensive activity approval process that I have ever seen in Government. I don't know of any other regulated entities whose everyday normal business practices would require approval by a Government agency filing in the Federal record, and then an independent determination by that agency whether it thinks it is a good idea.

Chairman BAKER. If I may suggest, you are just about out of time. In any event, we have two Members that want to wrap up and then we could perhaps close this hearing. Can we just proceed at this moment.

Ms. WATERS. Am I out of time yet?

Chairman BAKER. Well, you are about 10 seconds away.

Ms. WATERS. Were you stopping, Mr. Raines? You are finished?

Mr. RAINES. Yes, I am finished.

Ms. WATERS. Thank you very much.

Chairman BAKER. I thank you for your courtesy.

Mr. Ryan, and then we will go to you, Mr. Riley.

Mr. RYAN. Thank you, Mr. Chairman. I will try and be brief.

I would like to revisit the mortgage-backed security issue. My purpose for asking these questions, I am not trying to drive an agenda, I am just simply trying to get to some facts. It looks like there has been a change in policy by both Freddie and Fannie in that beginning in 1993, your share of outstanding mortgage-backed securities, the retention or the repurchasing or purchasing, whatever terminology you want to use, was for Freddie, 3.5 percent and for Fannie, 4.9 percent in 1993. That grew dramatically in 1999 to Fannie repurchasing or retaining 29.3 percent of the MBSs, and Freddie, 28.2 percent. So there is a dramatic increase in the retention or repurchasing of your mortgage-backed securities.

Let me start with you, Mr. Brendsel, because the last vote cut us off and I feel bad about that. Let me just ask two quick questions which I think you can answer very quickly. Does the repurchase or purchase, whatever terminology you choose to use, does that advance home ownership? Does the repurchase of a mortgage-backed security put a person into a home that they otherwise would not have been able to afford?

Mr. BRENDSEL. Yes.

Mr. RYAN. How so?

Mr. BRENDSEL. Because it provides additional liquidity, it reduces mortgage rates. It reduces costs.

Mr. RYAN. OK. So I think the point that is worth clarifying is that this is an interest rate risk, not a credit risk, and I think Mr. Bentsen brought that up, which is that bringing the mortgage-backed security back on your books represents an interest risk.

So are you saying that you are calculating the perceived reduction in interest rates by buying those mortgage-backed securities back on your books, does that exceed the interest risk that you are putting on your books by concentrating that risk or by repurchasing that mortgage-backed security?

Mr. BRENDSEL. I would put it this way. We are redistributing that risk to different investors through different techniques. If you go back to 1993, that period of time and prior to that, what you had developed during the 1990's is the market for additional types of financial instruments, callable debt, as an example, that didn't

really exist in the 1980's to be able to fund mortgage loans, mortgage-backed securities.

Mr. RYAN. The market has diversified and that is why the greater concentration of the repurchasing of these securities?

Mr. RAINES. Well, actually it is not a concentration. I think what Leland is saying is it actually disburses it. If you own the mortgage-backed security, you have all the risk. If we own it, we then share that risk with a lot of investors, some of whom buy callable debt, some of whom buy bullet debt, and the residual risk remains with us. So we can take that risk and spread it around to more people.

Mr. RYAN. OK. So by repurchasing the mortgage-backed securities, you are saying you are not concentrating that interest risk, that you are actually spreading that risk out?

Mr. RAINES. That is because we are in the risk management business, not in the risk aggregation business. We are in the business of taking risk and spreading it to the best possible investors. Sometimes we are the best investor, but usually we are not. Usually there are other people who are the better holders, so we give them what they want.

Mr. RYAN. I think it is clear and I think it would be irrefutable that a good profit is derived from repurchasing those mortgage-backed securities, correct, by Freddie and Fannie?

Mr. RAINES. But no different really than purchasing whole loans.

Mr. RYAN. But a profit is derived.

Mr. RAINES. Well, absolutely. We hope so. We hope so.

Chairman BAKER. Can you turn him loose? Because I want to get to Mr. Riley.

Mr. RYAN. I think we are going in circles here, but I appreciate having you spend the whole day here answering these questions. I would probably like to follow up another time and maybe we can meet in person to get to that issue.

Chairman BAKER. Thank you.

Mr. Riley.

Mr. RILEY. Thank you, Mr. Chairman.

Gentlemen, I want to thank you for staying here today. Your patience exceeds that of Job. But there are a couple of issues that I would like a clarification on.

Mr. Raines, if I understood your testimony today, you said that the actual proposal of this legislation had no impact on mortgage rates, if I understood you right?

Mr. RAINES. No. The only impact on mortgage rates was the people assuming that this legislation would be enacted. Because in a lot of countries, you know, it is not the long path from the introduction of legislation to it actually being enacted. They don't have a system like we do.

Mr. RILEY. OK. I guess that is my point. In your letter that all of us received, it says: "However, today, there is a bill, H.R. 3703, that has already had a negative impact on mortgage costs." Can you quantify that? Can you tell me how much of a negative impact there was?

Mr. RAINES. We can walk you through. It has varied over time.

Mr. RILEY. Give me a ballpark figure of what it costs. Was it 1 basis point, 100 basis points?

Mr. RAINES. Well, I think the impact that various outside observers have measured is anywhere between 20 basis points and 40 basis points, depending on the day.

Mr. RILEY. OK. Well, based on that, assume it was 20 basis points, and according to a statement made by someone in your organization that said that just the consideration of this bill would cost 208,000 families a chance at home ownership.

If that is based on 20 basis points, give me a calculation of how many houses that Chairman Greenspan has caused not to be financed in the last year-and-a-half. The best I can calculate if this is 20 basis points, then there would be 1,500,000 people that did not have the opportunity to buy a house because of the action of the Fed and Chairman Greenspan. Would that be an accurate assumption?

Mr. RAINES. Well, actually, it is much more complicated than that, because Chairman Greenspan only can affect the short-term rates directly. And when he raises short-term rates to fight inflation, which you will often find is long-term rates actually declining, so if Chairman Greenspan were sitting here he would explain to you, I think, and I hate to—I may say it more clearly than he might.

Mr. RILEY. I know he would appreciate that comment.

Mr. RAINES. I think he would say that his actions have actually helped home ownership, because he has held down long-term rates from where they were. But I think that would be his answer.

Mr. RILEY. So you are telling me that if he raises interest rates another one-half point today, it will lower long-term rates for most homeowners?

Mr. RAINES. Well, I think if the Fed is viewed as a credible inflation fighter, long-term rates would be lower than they otherwise would be, and I think we have seen some action of that just in the last few days. Just yesterday, long-term rates actually came down a little bit as people believed the Fed would step in and be a tough inflation fighter.

I am as big an advocate of growth as anyone, so I don't want to come across as being in favor of the Fed overreacting, but I do want to give them fair credit. Because of the Fed's, I believe—their very good management of the monetary policy, in conjunction with good fiscal policy, I think we have had lower home ownership costs in this decade than we otherwise would have, and I think that has been important.

Mr. RILEY. We are running out of time. But if this bill were enacted, how much of a rate increase do you believe there would be? Would it still be around 20 basis points, or would it be higher if we enacted the legislation that we are considering today?

Mr. RAINES. It is impossible to know, but I believe it would be significantly higher. I believe the 20 basis points was discounted by the likelihood of people thinking it was going to pass, but if people thought that these companies would be saddled with these restrictions, I think the rates would be substantially higher.

Mr. RILEY. Substantially, to 50 basis points, 100, 150?

Mr. RAINES. I would be guessing at that level.

Mr. RILEY. That is exactly what I would like for you to do; guess.

Mr. RAINES. I don't want to guess. I think one basis point that was unnecessary is too many. I mean every basis point that is necessary is all right, but one that is unnecessary I think is too many.

Chairman BAKER. If we can, gentlemen, we need to wrap this up, because Members need to make this vote. Mrs. Maloney wants to know, Mr. Raines, if Fannie Mae will take another creative look at Kiddie Mac.

Mrs. MALONEY. I really first want to thank you for this thoughtful hearing.

Maxine Waters mentioned earlier, new products. And there is one that I would hope that you would take a look at and expand to. I think it would be appropriate to bring the GSE structure to child care, an area that has been failed by the private markets. You literally revolutionized home ownership in this country, it is now at an astonishing 70 percent, yet child care, we can't get the financing. It is not supported. I would like to know, would Fannie and Freddie be opposed to having the authority to buy child care facility mortgages?

Chairman BAKER. If you would, let me suggest we are down now below five minutes on this vote. Please let me make the formal request that you respond to Mrs. Maloney and myself with regard to her question in writing at a later time, if that is acceptable.

Mrs. MALONEY. OK.

Chairman BAKER. Certainly any Member who has an interest in Kiddie Mac.

Chairman BAKER. Let me say thank you to all of you gentlemen for your time. I wish to announce that our next hearing on this subject will be June 7, and that next week we do expect to get a letter back from the Federal Reserve in response to our questions concerning systemic risk, which we will be sharing with the agencies.

Mrs. MALONEY. Mr. Chairman, who will the witnesses be at the next hearing?

Chairman BAKER. We are waiting on confirmations. We will have that for you next week.

Mrs. MALONEY. But what kind of witnesses?

Chairman BAKER. Good.

Mrs. MALONEY. Good witnesses.

Chairman BAKER. Yes. They will be financial.

But I do thank you for your courtesies. We do have follow-up questions. I think my staff has prepared some, and I would like to leave those with you as well. Thank you.

[The information referred to can be found on page 199 in the appendix.]

[Whereupon, at 2:15 p.m., the hearing was adjourned.]

APPENDIX

March 22, 2000

CURRENCY

Subcommittee on Capital Markets

Richard Baker, Chairman

For Immediate Release:
Wednesday March 22, 2000

Contact: Brookly McLaughlin
(202) 226-0471

Opening Statement
Of Rep. Richard Baker
Chairman, Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises
House Banking and Financial Services Committee
Housing GSE Regulatory Reform Hearing

The Committee meets today to discuss the "Housing Finance Regulatory Improvement Act," H.R. 3703. Chairman Leach and I introduced this bill to improve the regulatory structure of the three housing GSEs and thereby reduce the financial risk posed to taxpayers and the economy.

The bill is based on a GAO recommendation to consolidate regulation of the three housing GSEs into one independent board. Currently three agencies regulate the three housing GSEs. The Federal Housing Finance Board regulates the Federal Home Loan Banks for safety and soundness and mission compliance; the Office of Federal Housing Enterprise Oversight regulates Fannie Mae and Freddie Mac for safety and soundness; and the Department of Housing and Urban Development regulates Fannie and Freddie for mission compliance.

Although the current regulatory structure works, the GAO study concluded that a single independent regulator would lead to improved oversight and more effective regulation. GAO believes a single regulator would be more independent, objective and prominent in its oversight capacity.

H.R. 3703 proposes a five-member board consisting of the HUD Secretary, Treasury Secretary, and three citizen members appointed by the President and confirmed by the Senate. The board's principal duties would be to ensure the housing GSEs operate in a financially safe and sound manner, carry out their mission, and remain adequately capitalized.

The housing GSEs are large and growing larger. Their total debt obligation is about two-thirds of the roughly $3.5 trillion federal debt held by the public. By improving the existing regulatory structure of the housing GSEs in today's good economic climate, we can reduce future risk to the taxpayer and the economy.

This bill will give the board the authority to approve new activities pursuant to the public interest and review ongoing activities of the housing GSEs to ensure legal compliance. The non-mission related growth into capital markets by the housing GSEs is an area not covered sufficiently by the current regulatory structure. The board will be required to limit nonmission-related assets that the housing GSEs may hold at any time.

The bill will eliminate each GSEs' line of credit with the Treasury, require annual credit ratings and mandate a study of the effects a GSE failure would have on depository institutions.

This bill seeks to improve supervision and diminish systemic risk now rather than waiting for a time of crisis to expose the faults of a hobbled regulatory structure.

Today we will hear first from a representative of the Treasury Department who will identity the potential risks involved and advise us on how best to organize a regulatory structure to protect against this potential liability. After that, we will hear from the regulators of the housing GSEs who will provide us their expertise in how to set up a new regulatory framework. I look forward to the witnesses' comments on this legislation.

Statement for Rep. Judy Biggert (R-IL)
Hearing on H.R. 3703
The Housing Finance Regulatory Improvement Act
March 22, 2000

Mr. Chairman, it is a pleasure to be here this morning.

Homeownership is one of the core values we have as Americans and one of the most fundamental bases for stability in our communities.

Government sponsored enterprises have helped make the American Dream of owning a home a reality for thousands of renters and low income families.

For example, Fannie Mae has invested some $6.2 billion in mortgages in my district, providing mortgages money for some 60,000 families in Illinois' 13th Congressional District.

However, I do have some concerns about the safety and soundness and mission compliance of the GSEs and share your goals of streamlining the GSE regulatory process.

Therefore, Mr. Chairman, I very much look forward to this hearing and the others to be held in the future on this very important issue.

Thank you.

Opening Statement of Congressman Merrill Cook
March 22, 2000

In August of last year, Fannie Mae opened a partnership office in Utah. The purpose of this office is to work with the constituents and the lenders in my district to come up with innovative solutions to the housing problems facing the greater Salt Lake City area, and they are already having an impact.

Last month the local Fannie Mae office was able to partner with Neighborhood Housing Services of Salt Lake City to create the Home at Last program. Under this initiative, borrowers at or below 80% of area median income will be able to get into a home in Salt Lake for $1,000 down.

That said, I will be interested to hear the testimony of the witnesses here today and their responses to this bill. I believe as members of Congress we are accountable to the taxpayers and if we can improve the regulation and supervision of the housing GSEs then we should do so, but more importantly I am interested to see how consumers will stand to benefit from this legislation.

As the housing GSEs continue to pile on debt I think it is important for us to be watchful and diminish any systemic risk these GSEs may pose to the economy and taxpayers. $1.8 trillion outstanding debt is a lot of money and I thank Chairman Baker for having this hearing.

Fannie Mae and Freddie Mac currently are in compliance with the risk based capital standard which mandates that they have enough capital in place to endure a ten-year nationwide financial collapse – a standard far more stringent than the capital requirements for any bank, thrift, or any other financial services company. I am particularly interested to hear what the effects of creating a single regulator will be on this risk based capital structure.

America's housing finance system seems to be running fairly smoothly. It should be noted that the overall homeownership rate in America is approaching 68%. I want to be sure that this legislation will not prevent the housing GSEs from fulfilling their missions. The kinds of neighborhood specific solutions I spoke of earlier and very important to my district and to me.

I have a number of questions about the scope and intent of H.R. 3703, and I look forward to hearing the views of the witnesses on how <u>consumers</u> stand to benefit from this legislation.

OPENING STATEMENT

H.R. 3703
Housing Finance Regulatory Improvement Act

Good Morning, Chairman Baker, Ranking Member Kanjorski and Members of this Committee. Mr. Chairman, I ask unanimous consent that my full statement be included in the Record.

Mr. Chairman, H.R. 3703, the Housing Finance Regulatory Improvement Act, is a bill designed to improve regulation and supervision of the housing GSEs following GAO's recommendation to consolidate regulation of GSEs into one independent board. However, Mr. Chairman, I must say, from my reading of this bill, that the language "improve" GSEs regulation and supervision seems somewhat out of place.

As a former Prosecutor and Judge, my experience and training taught me how to focus on "intent", analyzing patterns and trends. In 1992, Congress passed Federal Housing Enterprises Financial Safety and Soundness Act (FHEFSSA) that mandated Fannie Mae and Freddie Mac to ***"lead the mortgage finance industry in making credit available for low- and moderate-income families."*** From my understanding of GSEs, they were fulfilling this mission. My question, then, is "Where Is the Problem?"

It is difficult, therefore, for me to find the intent of this bill other than to work to thwart the efforts of GSEs. This bill seems to be a solution in search of a problem. I must admit Mr. Chairman, I find it uniquely odd for your party, to call for greater regulation of anything, particularly in an area where there are no current deficiencies nor financial crisis. Fannie Mae and Freddie Mac have both received passing grades on each and every OFHEO (Office of Federal Housing Enterprise Oversight) capital adequacy test.

Mr. Chairman, while the interest of your legislation is laudable, in that it hopes to avoid a repeat of any bailout, I fail to see the payoff for all the regulatory burden of this bill. Simply mixing and matching regulators like people change clothing outfits will not produce, what I am most concerned about, more homeownership opportunities in Cleveland, Ohio. If anything, from my reading of this bill, it could dilute the GSEs' focus on housing. In light of the high flying politics of Washington, I cannot seem any improvement with a five-person politically appointed board as a model for safety and soundness regulation.

As a member of this committee and as Chairperson of the Congressional Black Caucus Housing Task Force, I have had the opportunity to see various products of both Fannie Mae and Freddie Mac. Those products, I believe, even as a housing finance novice, would be enticing to mortgage lenders in providing homeownership opportunities to families. I am not sold that this bill will somehow bring some magical lenders and other entities out to deal with creative ways of addressing affordable housing and homeownership.

Mr. Chairman, I am a realist. All about the Halls of Congress, we rave about our efforts to empower citizens. I want real empowerment for my constituents of the 11th Congressional District and for citizens all across this nation. Fannie Mae, in my district,

provided $371 million in mortgage financing to 5,484 families. Owning a home, Mr. Chairman, is the best form of empowerment.

Mr. Chairman, under H.R. 3703, any new product to expand homeownership would be subjected to a process more burdensome than the issuance of most government regulations—and certainly far more than what was in place in the 1992 GSE Safety and Soundness legislation. Some of us, on this committee, moan and groan about onerous regulations, layered governance and cry out, "if it ain't broke, don't fix it."

There is no way product creativity and innovation can occur when there is a 90-day waiting period, much like a new government program or regulation. With the growth and speed of the internet, technological advances, e-commerce and new e-mocracy, companies will not be successful under those constraints, thus consumers are hurt.

How do we reconcile, as a committee, calls for reduced regulations in just about every instance, and now call for increased regulation in a select few instances. We should call for regulations where regulations are warranted.

I hope that this hearing helps to clear the record. H.R. 3703 does not save the taxpayers money. It creates an unworkable regulatory burden. Also, this bill, I believe would cause great delays in bringing new products to the market and hinders, subsequently, new and innovative products to consumers.

I realize that there is much more to be done by GSEs with respect to affordable housing. I have been pleasantly surprised by HUD's Housing goals for the GSEs as well as Fannie Mae's new goal of reaching many more households.

Mr. Chairman, in the midst of positive news about housing, I do not see bringing forth additional regulations where there is not increase in safety nor soundness, which I thought should be the basis for any improvements.

Mr. Chairman, I want to be clear. Cleveland and Cuyahoga County are both undergoing a crisis in affordable housing. In order to address this crisis, I have been working with Fannie Mae in my district on challenging affordable issues as we speak. I see very little in the regulatory changes, that your bill makes, that would produce tangible benefits to my constituents in Cleveland, Ohio. Until someone can demonstrate to me a tangible "quality of life improvement" for families living on the East side of Cleveland, I will remain opposed to this bill.

PAUL E. KANJORSKI
11TH DISTRICT, PENNSYLVANIA

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FINANCIAL SERVICES

RANKING MEMBER
SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES,
AND GOVERNMENT SPONSORED ENTERPRISES

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**OPENING STATEMENT OF
RANKING MEMBER PAUL E. KANJORSKI
SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES,
AND GOVERNMENT SPONSORED ENTERPRISES**

**HEARING ON H.R. 3703,
THE HOUSING FINANCE REGULATORY IMPROVEMENT ACT**

WEDNESDAY, MARCH 22, 2000

Mr. Chairman, thank you for the opportunity to speak briefly about H.R. 3703, the Housing Finance Regulatory Improvement Act, the subject of today's hearing.

Let me begin my remarks by once again commending the Chairman for his leadership. In H.R. 3703, he has developed a legislative proposal certain to provoke considerable public debate about the future regulation of the housing government-sponsored enterprises, or GSEs. He has also focused our Subcommittee in recent years on a number of public policy issues affecting the operations of GSEs. Last year, for example, I worked closely with him to finally enact legislation to reform the operations and mission of the Federal Home Loan Bank System.

Additionally, as a result of the Chairman's initiative, our Subcommittee held several hearings in the 105th Congress on the effectiveness of the Office of Federal Housing Enterprise Oversight, the Department of Housing and Urban Development, and the Federal Housing Finance Board in pursuing their respective mission compliance oversight and safety and soundness supervision objectives. The Chairman also requested and received a series of reports from the General Accounting Office about the operations of the current GSE regulators. Then, after building a substantial legislative history about the performance of the GSE supervisors, the Chairman introduced H.R. 3703 in the 106th Congress, a bill designed, among other things, to create a single overseer for the housing GSEs.

From my perspective, we need to have strong, independent regulators that have the resources they need to get the job done. Moreover, as one of the few remaining Members of the Committee who experienced the Congressional battle to resolve the savings and loan crisis, I am acutely aware of the need to protect taxpayers from risk. It is in the public's interest that we maintain a strong regulatory regime over Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. I am, therefore, pleased that our current GSE regulators are operating effectively.

Additionally, our nation's current system for housing finance is not only extremely successful, but it is also the envy of the world. Almost 67 percent of Americans own the homes in which they live. This success, however, should not stop us from asking whether and how we can do a better job of increasing homeownership rates. We should always examine ways by which we can lower mortgage rates and improve regulatory efficiency.

That said, we should move forward cautiously in this area The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 is only now beginning to produce its intended results. By the end of this year, OFHEO hopes to finalize its dynamic risk-based capital standard for Fannie Mae and Freddie Mac. That rule will further help to protect taxpayers against systemic risk. HUD will also complete its work on updating the affordable housing goals for the two enterprises. These goals, as I understand, will force the GSEs to aggressively increase lending in underserved areas. Finally, the Finance Board is developing the many regulatory changes needed to implement the Federal Home Loan Bank Modernization Act of 1999. The creation of a single regulator at this time could delay all of these important activities

Furthermore, pursuing significant legislative changes could upset the housing finance marketplace. Fannie Mae, Freddie Mac, and the Federal Home Loan Banks all help to lower mortgage rates for consumers. We must work to ensure that our work does not raise those costs for consumers or inappropriately discourage investors.

In closing, I hope that we are not on a fast track toward marking up this legislation. There is no pressing need for reform at this time. We should, however, carefully, deliberately, and objectively proceed in examining the public policy issues related to the mission compliance and safety and soundness regulation of GSEs. I look forward to debating the merits of this legislation.

Committee on Banking, Subcomittee on Capital Markets
Hearing on Oversight of GSE's
Congressman John E. Sweeney
March 22, 2000

I thank the Chairman, Mr. Baker, for the opportunity to address this important issue of oversight of GSE's.

I agree with the Chairman that the Congress, and particularly this subcommittee, should be actively engaged in oversight of the housing GSE's. It is our responsibility to assure the public that they are acting in a manner that is financially responsible and that they are utilizing their charters to achieve their intended purpose of improving affordable home ownership.

That said, our country's housing finance system is the envy of the world and has provided Americans with greater access to home financing than at any point in history. Some of that success must be attributed to the contributions of the GSE's to the secondary mortgage markets.

As a new member of the Banking Committee, I was not involved in past deliberations which produced the 1992 GSE charter revisions that created OFHEO and the housing goals for Fannie Mae and Freddie Mac. Therefore, I am looking forward to the testimony of the witnesses to describe the effects of the legislation before us in light of these past actions taken by the Congress.

I am also concerned that any effort undertaken here should encourage innovation in the marketplace and fair market competition – and should not burden the mortgage marketplace with unnecessary regulations. Lastly, we need to ensure that we are not jumping to address a problem that is not there.

I come to this hearing with an open mind and look forward to the testimony of the witnesses today and to future hearings and discussions on this issue.

Statement of

Honorable Lee Terry

Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises

March 22, 2000

H.R. 3703, Housing Finance Regulatory Improvement Act of 2000

Mr. Chairman, H.R. 3703, the Housing Finance Regulatory Improvement Act of 2000 is being addressed at a time when more people are buying affordable homes with the assistance of FannieMae, FreddieMac and Federal Home Loan Banks. Since the establishment of these three government sponsored-enterprises, these enterprises have provided American's with the reality of a dream- the dream to own their own home. All three government sponsored-enterprises have pursued a mission to provide financial products and services that increase the availabilty and affordability of mortgage credit for low-, moderate, and middle-income Americans. These government sponsored-enterprise's have effectively played an invaluable role in making the American dream of owning a home reality.

Since FannieMae, FreddieMac and Federal Home Loan Banks have been efficient and effective in providing affordable homes to American's for nearly a decade, we should not initiate a regulatory regime that could adversely affect their successful ability to continue to provide Americans with their dream of owning a home. Reforming and

consolidating the current regulatory structures that oversee FannieMae, Freddie Mac and Federal Home Loan Banks could put a severe encroachment on these enterprises. The combination of the federal oversight regulators of these companies would create an inefficient, incoherent and ineffective bureaucratic structure that would impose a new set of regulatory requirements and impediments on companies whose mission is to facilitate the efficient delivery of affordable housing.

H.R. 3703 does not address the fact that Federal Home Loan Banks and FannieMae and FreddieMac have capital regimes and requirements that are different. Not only are their capital regimes different, but the housing goals for Federal Home Loan Banks and FannieMae and FreddieMac are also different. This bill does not make any effort to conform the difference in capital regimes and housing goals. The lack of conformity would provide for a very cumbersome responsibility for the new overseeing regulator by having the duty to carry out two very different schemes of regulation.

If enacted into law, H.R. 3703 could hamper product innovation. Under this legislation, any new product or housing finance activity that would expand homeownership would be subjected to the formal notice-and-comment process. It gives the new regulator the discretion and responsibility to determine if the public should have access to this new product or housing finance activity. This process is burdensome, slow and encroaches on the ability of these government sponsored-enterprises to effectively provide homes to Americans.

Another concern that I have with this legislation is the fact that it gives the new regulator the ability to make any corporate data about the companies, open to the public. This unfettered discretion that the new regulator would have, would be a strong deterrent to innovation. Consumers would suffer as a consequence of this action.

This legislation has the potential of creating an unworkable regulatory burden on the secondary mortgage market. FannieMae, FreddieMac and Federal Home Loan Banks have been effective in doing their job by providing Americans with the ability to own their own homes. We should not impede upon these institutions and their ability to continue their tireless and invaluable efforts to make home ownership more affordable and accessible to current and potential homebuyers by adding a new level of regulation.

TREASURY UNDER SECRETARY GARY GENSLER
HOUSE BANKING SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES AND GOVERNMENT SPONSORED ENTERPRISES

Mr. Chairman, Representative Kanjorski, Members of the Subcommittee, I appreciate the opportunity to testify on the supervision and regulation of government sponsored enterprises. Your bill, H.R. 3703, the *Housing Finance Regulatory Improvement Act*, focuses on the supervision and regulation of three government sponsored enterprises (GSEs) whose original purpose was devoted to housing. I will divide my remarks into four parts: first, a general discussion on the background of GSEs; second, a description of the GSEs' role in the capital markets; third, a discussion of Treasury's general approach to mitigating systemic risk in capital markets; and fourth, the Administration's view on how aspects of the Baker bill meet this general approach.

The nation's interest in a vital housing market is strong. Congress originally created the housing GSEs -- the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal Home Loan Bank System -- to improve consumers' access to mortgage credit. These three GSEs have done much for home ownership in this country. Fannie Mae and Freddie Mac, along with government-owned Ginnie Mae, helped create a market for mortgage securitization. Credit from Federal Home Loan Banks, along with the creation of the Federal Housing Administration, helped banks and thrifts to establish the long-term, fixed-rate mortgage in the 1930s and 1940s.

Currently, we are enjoying the longest period of economic growth in our history. Our financial markets have unquestionably been major contributors to America's economic success, and our financial sector continues to be the world leader. Our capital markets are the most competitive and efficient in the world. They generally operate without the government providing differential treatment among financial institutions.

Government sponsored enterprises are an exception to this general approach because the government provides them benefits in order to affect market outcomes. The potential benefits that GSEs bring to a particular market must be balanced, therefore, against potential risks to the financial system and potential effects on market competition.

Reconsideration of this balance is appropriate from time to time and as financial conditions change. The GSEs have significantly increased both their size and their market share. They have now become the dominant institutions in the secondary mortgage market, and constitute an increasing percentage of the overall credit markets. At the same time, our government's fiscal discipline is leading to less Treasury debt. Together, these factors have caused the GSEs to occupy a more central role in capital markets than ever before.

At the same time, technology and innovation have revolutionized capital markets. Markets are broader and more efficient than they have ever been. Our capital markets have developed increasingly sophisticated techniques for securitizing mortgages and other assets, broadening the holders of mortgages and lessening the need for government intervention.

The housing markets and the overall economy are currently strong. With no particular problems on the horizon, this is an ideal time to review the supervision and regulation of the GSEs.

What are GSEs?

GSEs are privately owned but federally chartered companies, created by Congress to help overcome barriers to the flow of credit into certain segments of the economy. [1] Fannie Mae and Freddie Mac are publicly traded companies. The Federal Home Loan Banks are cooperatives owned by their member banks and thrifts.

The federal government created the Federal Home Loan Bank System in 1932 to provide credit to illiquid thrifts and to encourage the development of long-term, fixed-rate mortgages. Freddie Mac was created, and Fannie Mae was transformed from a government corporation to a GSE, during the turbulent financial period of the late 1960s and early 1970s. One of the primary goals of creating Fannie Mae and Freddie Mac was "... to provide supplementary assistance to the secondary market for home mortgages by providing a degree of liquidity for mortgage investments, thereby improving the distribution of investment capital available for home mortgage financing."[2]

During the 1970s, Fannie Mae provided this assistance primarily by buying mortgages while Freddie Mac concentrated on securitizing mortgages. As there was not a significant secondary market for conventional mortgages at the time, the two GSEs provided assistance to the traditional originators and holders of mortgages, such as thrifts and mortgage banks. By the 1980s, however, securitization had broadened the potential holders of mortgages. Pooling mortgages into securities brought many more potential purchasers into the secondary markets for home mortgages. Freddie Mac and Fannie Mae helped lead the development of this important market.

With rising interest rates in the early 1980s, Fannie Mae's cost of funds rose above the interest rate it was earning on its long-term, fixed-rate mortgages. This interest rate mismatch was similar to that faced by the savings and loan industry. Fannie Mae became insolvent on a mark-to-

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[1] Today there are five GSEs: Fannie Mae; Freddie Mac; the Federal Home Loan Bank System; the Farm Credit System; and Farmer Mac. A sixth GSE, Sallie Mae, is in the process of being fully privatized.

[2] See Federal National Mortgage Association Charter Act, sec. 301(a) (amended 1989); See also S. Rep. 91-761, 91st Cong., 2d Sess. 7 (April 7, 1970) (explaining Freddie Mac's mission: "The Corporation (Freddie Mac) would be a supplement to, and would have parallel authority to, the Federal National Mortgage Association under its expanded authority proposed by title II of the bill.").

market basis. A combination of legislative tax relief, regulatory forbearance, and a decline in interest rates allowed Fannie Mae to grow out of its problem. Also, the Farm Credit System was in serious financial trouble in the late 1980s, and the federal government ultimately provided financial assistance to the System.

In 1989, Congress restated Fannie Mae's and Freddie Mac's charters, directing the GSEs to "provide stability" and "ongoing assistance to the secondary mortgage market."[3]

Since the early 1990s, each of the three housing GSEs has significantly expanded the size and scope of its activities. The FHL Banks now provide both banks and thrifts with advances. In addition, the FHL Banks now directly hold approximately $170 billion in investments. Similarly, Fannie Mae and Freddie Mac now derive significant earnings from purchasing their own mortgage-backed securities in the market. Fannie Mae and Freddie Mac now hold about $850 billion of mortgages and mortgage-backed securities in portfolio, plus another $80 billion in non-mortgage securities.

Today, the GSEs are large, sophisticated financial institutions that retain and manage credit, interest rate, and liquidity risks. They are owned by the private sector. In these ways, the GSEs are very similar to other large financial institutions. As financial institutions, the GSEs earn money in four basic ways:

Credit Guarantees. Fannie Mae and Freddie Mac purchase mortgages and issue mortgage-backed securities on which they guarantee the timely payment of principal and interest. This credit enhancement is similar to what Ginnie Mae and FHA do for securities backed by FHA mortgages. As of year-end 1999, guarantees by Fannie Mae and Freddie Mac totaled $1.2 trillion.[4] On average, they charged roughly 19 basis points (nineteen one-hundredths of a percentage point) per dollar of security guaranteed. The GSEs bear the credit risk of individual borrowers defaulting on their mortgages after losses covered by private mortgage insurance. While in the mid-1990s losses averaged 5 to 6 basis points, last year they subtracted only about 1 basis point from the 19 basis points charged.

Mortgage Investments. All three housing GSEs purchase whole mortgages, mortgage-backed securities, and other mortgage-related securities in the capital market. By the end of 1999, the three GSEs held about $920 billion of such assets. The GSEs take on three forms of risk with these investments -- credit risk, interest rate risk and liquidity risk. An important component of interest rate risk relates to forecasting the behavior of borrowers in prepaying their mortgages. In addition, the history of financial markets shows that the significance of liquidity risk increases with size and leverage.

Similar to other financial institutions, the GSEs choose to hold and manage risk rather than attempting to completely hedge it. They thereby seek to increase returns to their shareholders. Thus, the GSEs earn a spread between the interest rate on their mortgage investments and their own

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[3] Financial Institutions Reform, Recovery, and Enforcement Act, Pub. L. No. 101-73, sec. 731(m)(1), 103 Stat. 183, 435 (August 9, 1989) (codified at 12 U.S.C. sec. 1716).

[4] This figure excludes securities held in portfolio by Fannie Mae and Freddie Mac, as the GSEs are the beneficiary of their own guarantee.

below-market cost of funds. This spread has recently been approximately 80 basis points per dollar of assets for Fannie Mae and Freddie Mac, and about 50 basis points for the Federal Home Loan Banks.

Advances. The Federal Home Loan Banks make secured loans, called advances, to the approximately 7,000 banks and thrifts that are System members. These subsidized funds are frequently used by the member to make further mortgage loans, but are also used for non-housing purposes. The Federal Home Loan Bank System Modernization Act liberalized the uses to which small institutions can put those advances. As of year-end 1999, outstanding advances totaled $396 billion, on which the FHL Banks earned about 20 basis points per dollar of advance.

Non-Housing Investments. All three housing GSEs invest in non-housing assets such as asset-backed securities, commercial paper, and other money market instruments. As of year-end 1999, the GSEs held about $180 billion in non-housing assets. Generally, the spreads earned on these investments are smaller than the GSEs' other business lines, ranging between roughly 10 and 30 basis points per dollar of asset.

Benefits of GSE Status

The GSEs' growing role in the capital markets is aided by the numerous benefits derived from their federal charters. The GSEs receive no funds from the federal government, and the government does not guarantee their securities. GSE status, however, does provide a set of benefits that are not available to other financial institutions. These statutory benefits are listed in an appendix to my testimony.

Taken together, these statutory benefits provide the GSEs with three advantages in financial markets: lower funding costs; the ability to operate with less capital; and lower direct costs. These advantages have been identified by past government studies of the GSEs, notably studies by the Congressional Budget Office, the General Accounting Office, and the Treasury Department in 1996, and studies by these same agencies in 1990 and 1991.

Funding. First, the GSEs are able to borrow money at lower interest rates than other financial institutions. Over the last six months, the GSEs borrowed at approximately 40 basis points less than AA-rated banking and financial firms on one- and five-year debt. The spread to AA-rated financial firms is particularly relevant since Standard and Poor's gave Fannie Mae and Freddie Mac a "risk-to-the-government" rating of AA- in 1996, the last time such a rating has been done. Even if one compares to AAA-rated banking and financial firms, the advantage still averaged almost 30 basis points. They also borrow at approximately 18 basis points below three-month LIBOR, which represents the rates at which banks generally obtain inter-bank funding. These spreads may widen or shrink over time. What remains true, however, is that the GSEs operate with a significant funding advantage over other private companies in equal or better financial condition.

Leverage. Second, GSEs operate with less equity capital per dollar of debt than other financial institutions. Fannie Mae and Freddie Mac have roughly $32 of debt for each dollar of capital. The FHLBanks have roughly $19 in debt per dollar of capital. In contrast, per dollar of capital, large

banks have about $11.50 of debt, thrifts have $12.50 in debt, and the five largest securities firms have approximately $25 in debt.

Lower direct costs. Third, GSEs receive direct cost savings from their charters. In 1999, the GSEs saved approximately $280 million by being exempt from SEC registration. In addition, Fannie Mae's and Freddie Mac's exemption from state and local taxes was worth approximately $690 million for 1999, based on the GAO's 1996 estimate that this exemption saved those GSEs about 8 percent of net income.

These funding, leverage and cost advantages are particularly significant to the GSEs because of the markets in which they operate. The U.S. capital markets are the most competitive and efficient in the world. Relatively small advantages, even those measured in single basis points, over time can allow firms to dominate their markets.

While a portion of these benefits is passed on in lower mortgage rates, the rest of the cost reductions provide higher returns to GSEs' shareholders. Studies conducted by Treasury, CBO, and GAO over the past ten years concluded that the GSEs retain a significant amount of their federal subsidy. Although those estimates have not been updated recently, the high return on equity of the publicly traded GSEs in part suggests that this pattern continues. Between 1995 and 1999, Fannie Mae and Freddie Mac's average return on equity was about 24 percent. In comparison, over that same time period, large banks' average return on equity was 15 percent, large thrifts' average return was 12 percent, securities firms averaged 17 percent, and the largest insurance firms averaged 12 percent.

GSEs in the Capital Markets

The advantages of GSE status have also enabled the GSEs to grow rapidly and gain an increasing share of the capital markets. The GSEs now control a central position in the mortgage market and an increasing share of the U.S. debt markets.

<u>Size</u>

The $1.4 trillion of GSE debt is large on any relative scale. It is now roughly the size of the entire municipal bond market – the outstanding debt of the fifty states and localities that issue publicly traded debt. The GSEs' debt of $1.4 trillion is now more than one-half of the $2.7 trillion of outstanding privately held marketable Treasury debt.[5] Adding the $1.2 trillion in GSE-guaranteed mortgage-backed securities to the mix, GSE involvement in the credit market is approaching the size of the Treasury market.

<u>Expected growth</u>

Based upon recent trends and growth forecasts, GSE debt may double to $3 trillion by 2005. With the government's continued fiscal discipline, GSE debt is forecast to surpass privately held marketable Treasury debt in the next three years.

[5] This is the most relevant measure of Treasury debt for comparisons of market size, as it excludes amounts held by the Federal Reserve and non-marketable securities such as Savings Bonds and those held by municipalities.

As the Treasury market declines in size, financial markets will be able to make a smooth adjustment. Investors and hedgers will be able to switch to other securities and derivatives, including those of GSEs. In this environment, the GSEs have been promoting their debt securities as an alternative market benchmark. Like other large firms, the GSEs see benefits in having fewer, more liquid issues of their debt. Such efforts could lower the GSEs' funding costs and increase their returns to shareholders. In addition, futures contracts on Freddie Mac and Fannie Mae debt securities began trading last week. These are the first contracts on individual private sector debt securities to trade on the futures exchanges.

The Federal Reserve has principally used Treasury securities and repurchase transactions on Treasury securities to carry out monetary policy. Although the Federal Reserve does not currently purchase GSE debt securities, it has done so in the past and in recent years increasingly has used their debt as collateral for repurchase agreements. Furthermore, in response to liquidity needs spurred by Y2K concerns, the Federal Reserve began to take GSE-guaranteed mortgage-backed securities as collateral in repurchase agreements.

Share of Mortgage Market

The GSEs have become the dominant institutions in the secondary mortgage market. Over the last decade they have grown over four-fold, from just over $300 billion in size to $1.4 trillion. As of year-end 1999, Fannie Mae and Freddie Mac either owned or guaranteed roughly 63 percent of all outstanding conforming, conventional mortgages. Their retained portfolio of mortgages currently represents 26 percent of outstanding conforming, conventional mortgages.

To the extent that the GSEs now finance a significant portion of their sector of the mortgage market, the willingness of a GSE to purchase a mortgage has become a far more significant factor in deciding whether to originate that mortgage. The GSEs' automated underwriting systems are increasingly becoming the means by which originators decide to lend. This technology will make the process more efficient. In the long run, however, this trend may result in less diversity in credit decisions and less price competition.

Ownership of GSE Debt by Depository Institutions

GSE debt also has become a significant portion of the assets of the banking system. Banks held over $210 billion in GSE debt at mid-year in 1999. This constituted just under 4 percent of total bank assets and over one-third of total bank capital. Banks held 75 percent more GSE debt than their holdings of Treasury securities. In addition, banks held over $355 billion in mortgage-backed securities guaranteed by the GSEs.

To protect the exposure of banking institutions, current law places limits on an individual bank's credit exposure to any one entity. National banks may hold no more than 10 percent of their capital in the corporate bonds of any one issuer or lend unsecured more than 15 percent of their capital to any one borrower. Most state banks are subject to similar limits. Among all debt securities issued by private companies, however, only GSE debt securities are exempt from this investment limit.

Principles for Mitigating Systemic Risk

As the GSEs continue to grow and to play an increasingly central role in the capital markets, issues of potential systemic risk and market competition become more relevant. In 1997, Treasury established an Office of GSE Policy in order to monitor these issues.

Treasury's general approach to mitigating systemic risk in capital markets emphasizes the role of the private sector. The public sector has three roles: creating an environment in which market discipline can work effectively; promoting the maximum degree of transparency; and maintaining the competitiveness of the system as a whole. For institutions where the public has a special interest - for example, depository institutions carrying federal deposit insurance - further government involvement such as on-site examinations and capital standards is appropriate.

Promoting market discipline means crafting government policy so that creditors do not rely on governmental intervention to safeguard them against loss.

Transparency is the necessary corollary to market discipline. The government cannot impose market discipline, but it can enhance its effectiveness by promoting transparency. Transparency lessens uncertainty and thereby promotes market stability.

Promoting competition in financial markets lessens systemic risk. The task of public policy must be to ensure the stability and integrity of the market system. In any sector of the financial market, the dominance of one or two firms can lessen competition and the efficiency of the market pricing mechanism. In addition, the entry of a subsidized financial institution into a market may motivate other firms to take on greater risks and weaken their operating results.

We also recognize the important role this Committee has played in addressing risk in the capital markets. Most recently, the Committee reported out a hedge fund bill supported by the President's Working Group on Financial Markets.

H.R. 3703

Mr. Chairman, I appreciatc your efforts to highlight these issues and would now like to turn to your legislative proposal, which takes various steps to accomplish these goals.

Promoting Private Market Discipline

H.R. 3703 contains several provisions designed to promote private market discipline.

H.R. 3703 repeals the housing GSEs' conditional line of credit with the Treasury. Congress first authorized the Secretary of the Treasury to lend to the housing GSEs decades ago. The dollar amounts of these lines of credit are now a mere fraction of the GSEs' actual borrowings. For example, since its line of credit was established at its current level in 1957, Fannie Mae's mortgage holdings have increased 320 times in size. Each of the GSEs has gone from being a small, relatively unknown borrower in the capital markets to being among the largest debt issuers in the

world. Any function the lines perform at this point is purely symbolic. Repeal of the line of credit would be consistent with the congressional requirement that all GSE securities carry a disclaimer that they are not obligations of the U.S. government. Thus, as part of a package of reforms, we would support repeal of the line of credit.

The bill also repeals the Federal Home Loan Banks' so-called "superlien". A law adopted in the midst of the thrift crisis treats a Federal Home Loan Bank's secured, but not perfected, interest in any collateral as having a priority over any other secured, but not perfected, interest in that same collateral. Because the Banks need not take the legal steps necessary to perfect, they typically place a general, or "blanket," lien on most or all of a member's mortgage assets. If the member fails, the combination of the superlien and blanket lien places a Federal Home Loan Bank in a position superior to other secured creditors who have not perfected their interests. Repealing the superlien would restore market discipline by increasing the Banks' incentives to distinguish among their members with regard to credit risk. This in turn would reduce risk to the deposit insurance fund and taxpayers.

For the same reasons, we believe that the Committee should consider repealing a provision of current law that requires the federal banking agencies to provide confidential bank examination ratings to the Federal Home Loan Banks. No other lender possesses this information. We believe that GSEs, just like any other private sector financial institution, should not have access to confidential governmental examination data.

H.R. 3703 provides new authority to appoint a receiver to resolve a troubled GSE. This provision grants the GSE regulator powers comparable to other regulators of government chartered companies. For example, the Comptroller of the Currency can appoint a receiver for national banks. The availability of this authority would contribute to market discipline and enhance stability in the event there were ever a market strain.

Increasing Transparency

H.R. 3703 contains several provisions that increase transparency.

The bill allows the regulator to make public information that it determines would increase the efficiency of the secondary mortgage market or the housing finance system. This provision could enhance transparency. In crafting such language, however, it would be appropriate to recognize that some data is proprietary and may not be appropriate for public disclosure.

The bill also requires the GSEs to obtain an annual credit rating from nationally recognized statistical rating organizations. Such ratings could improve transparency and market discipline by giving investors an independent view of the GSEs' financial condition. It would also be a useful outside tool for the regulator. In determining such ratings, the bill specifically requires the ratings agencies to consider that the United States government does not guarantee the GSEs' obligations. Current law authorizes OFHEO to obtain ratings. We believe this proposal is an improvement over current law, as it requires annual ratings and specifically sets a standard for such ratings.

Promoting Market Competition

H.R. 3703 also contains provisions that are designed to preserve market competition, reducing the potential for subsidized competitors to distort financial markets. Limiting the new activities of the GSEs also has the potential to limit their scale.

The bill sets up a mechanism whereby the regulator would have authority to approve new activities. We have some concern that the notice and comment procedures for such approvals could interfere with the ability of the enterprises to innovate, while leaving the regulator to interpret a rather vague standard. We believe that it is appropriate for Congress, the chartering authority, to provide clear guidance about what activities the enterprises' charters allow and how broadly they should be interpreted. For example, to what extent does Congress wish the GSEs to expand from their current housing finance business into general consumer finance or mortgage origination?

Limiting the non-mission investments of the housing GSEs could also increase their focus on mission-related activities. Such an action could enhance accountability for the GSEs' benefits, and improve market competition.

Other Restrictions

Exposure Limits

The bill highlights an important issue – the potential for problems at one financial institution to cause instability in the financial markets or at other institutions. As I noted earlier, GSE debt obligations are exempt from banks' investment securities limits. We believe that Congress should seriously consider the best way to repeal such exceptions, including a sufficient transition period to prevent any market disruption.

Further Regulatory Authority

H.R. 3703 also addresses the regulatory structure for the GSEs. We believe that there is an appropriate regulatory oversight role with respect to the GSEs. First, oversight is appropriate to determine whether government sponsored enterprises carry out their public mission, as Assistant Secretary Apgar will later explain. Second, there is also a role for oversight of their financial condition. Such regulatory role should reflect, however, the fact that GSEs are private sector firms with uninsured liabilities.

We believe that any regulator charged with oversight of the financial condition of the GSEs must have a clearly defined and limited mandate. The bill grants the GSE regulator greater flexibility in setting capital standards than current law permits. We support such flexibility, though Congress may wish to provide the regulator greater guidance on the goals of capital regulation in the GSE context.

We believe that the standard for regulation and the tools available to the regulator are issues of primary importance. But the identity of the regulator is important as well. We agree with you,

Mr. Chairman, that it may be appropriate to have common regulators for the three housing GSEs. We also believe that supervision of GSEs should be a duty of the Executive Branch of government, which is charged with economic policy, including banking and housing policy. Responsibility for regulating financial condition could be placed with an agency responsive to those in the Executive Branch who oversee the soundness of the financial system. Experts in housing could supervise mission.

That said, we would not wish for regulatory reform to interfere with current efforts by existing regulators. For example, we support the efforts of the Office of Federal Housing Enterprise Oversight to finalize its risk-based capital rule and the Department of Housing and Urban Development to finalize its affordable housing goals. Any regulatory consolidation should allow this effort to be completed without interruption.

In any regulatory scheme, there may be important interactions between regulating mission and regulating financial condition. Congress can best balance these interests by giving the regulators clear guidance as to the mission of the GSEs and the standard for regulatory oversight. Furthermore, although the three housing GSEs share a common overall goal – increasing the availability of credit for housing – the charter of the Federal Home Loan Banks mandates a different business from the charter of Fannie Mae and Freddie Mac. Each GSE should be focused on those market failures they were intended to solve. By clearly specifying the mission of each GSE and the regulatory standards for their financial health, Congress can best promote housing finance while providing for financial regulation for these GSEs.

Conclusion

Mr. Chairman, the economy and the financial markets are strong. With no particular problems on the horizon, this is an ideal time to review the supervision and regulation of the GSEs. The GSEs play a central role in the nation's housing finance and debt markets. Thus, your Committee is providing a valuable service by thinking through the best framework for supervision and regulation of these enterprises. These are important matters of public policy that require balanced, thoughtful review by all interested parties.

APPENDIX A

The following benefits of GSE status are contained in the GSEs' charter acts and other laws:

- Their debt and mortgage-backed securities are exempt from registration with the Securities and Exchange Commission.
- The GSEs are exempt from state and local corporate income taxes.
- The GSEs have a line of credit from the Treasury that authorizes Treasury to purchase up to $2.25 billion of Fannie Mae's and Freddie Mac's obligations and up to $4 billion of the Federal Home Loan Bank System's obligations.
- Banks are permitted to make unlimited investments in GSEs' debt securities, whereas there are limits placed on their investments in any other company's debt securities.
- GSE securities are eligible as collateral for public deposits and for loans from Federal Reserve Banks and Federal Home Loan Banks.
- GSE securities are lawful investments for federal fiduciary and public funds.
- GSEs are authorized to use Federal Reserve Banks as their fiscal agents, including issuing and transferring their securities through the book-entry system maintained by the Federal Reserve.

STATEMENT BEFORE THE HOUSE BANKING AND FINANCIAL SERVICES COMMITTEE SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES, AND GOVERNMENT SPONSORED ENTERPRISES

WASHINGTON, DC
MARCH 22, 2000

BY

WILLIAM APGAR
ASSISTANT SECRETARY FOR HOUSING
FEDERAL HOUSING COMMISIONER

Statement of William C. Apgar
Assistant Secretary for Housing
Federal Housing Commissioner

Before the
House Subcommittee on
Capital Markets, Securities and Government Sponsored Enterprises
Committee on Housing, Banking and Financial Services
March 22, 2000

Chairman Baker and members of the subcommittee, my name is William Apgar and I am the Assistant Secretary for Housing/Federal Housing Commissioner at the U.S. Department of Housing and Urban Development (HUD). I am pleased to be here today on behalf of HUD Secretary Andrew Cuomo, and would like to thank you for the opportunity to testify on the Housing Finance Regulatory Improvement Act, H.R. 3703.

To place my comments today into perspective, I will offer a brief summary of HUD's current regulatory activities as they relate to Fannie Mae and Freddie Mac. Under the leadership of Secretary Andrew Cuomo, HUD has achieved a solid record as an effective regulator. Even so, more could be done to enhance the oversight of these two entities. To the extent that provisions in H.R. 3703 strengthen regulatory oversight of the Government Sponsored Enterprises, or GSEs, they merit careful consideration. More effective regulation will help ensure that Fannie Mae and Freddie Mac, as well as the Federal Home Loan Banks, are achieving their public purposes as mandated by Congress.

HUD's CURRENT OVERSIGHT IS EFFECTIVE

Recognizing that Fannie Mae and Freddie Mac enjoy tremendous advantages over their private sector competitors the Department is actively involved in ensuring that Fannie Mae and Freddie Mac achieve their public responsibilities. Under the leadership of HUD Secretary Cuomo, HUD has recently proposed substantial increases in the affordable housing goals, initiated a major review of Fannie Mae's and Freddie Mac's automated underwriting systems, and stepped-up its oversight of the GSEs' non-mortgage investment portfolios. Let me review our accomplishments in these and other areas with you.

Proposed Increases to Affordable Housing Goals

In July 1999, Secretary Cuomo announced a plan to increase Fannie Mae's and Freddie Mac's affordable housing goals. The higher goals, announced after a period of extensive consultations with Fannie Mae and Freddie Mac, will require the two

enterprises to purchase $2.4 trillion in mortgages over the next 10 years, providing affordable housing for about 28.1 million low- and moderate-income families. The higher levels for the three Congressionally mandated goals will increase their mortgage purchases by $488.3 billion over the next 10 years, providing affordable housing for seven million more low- and moderate-income families than they currently serve. The rule proposing the increased housing goal levels was published in the Federal Register on March 9, 2000 and comments are due to the Department by May 8, 2000.

The substantially higher goals will require that at least half of all of Fannie Mae's and Freddie Mac's mortgage purchases will benefit families of low- and moderate-income. Fannie Mae and Freddie Mac have been successful in meeting their housing goal requirements in the past, yet their share of the affordable housing market is substantially smaller than their share of the total conventional conforming market. Lower income families, certain minorities, central-city residents, and immigrant populations continue to be underserved by Fannie Mae and Freddie Mac. These new more challenging goal levels will close the gap between the GSEs' performance and the opportunities available in the primary markets.

For example, in 1997, the GSEs purchased mortgages financing 39 percent of all owner occupied and rental units available in the market, but only 30 percent of the units available to low- and moderate-income families, 24 percent of the special affordable units available in the market, and 33 percent of the units located in underserved areas.

Additionally, when GSE mortgage purchases are analyzed by property type, it becomes clear that the GSEs' purchases of mortgages on multifamily properties, particularly small multifamily properties, lag those that are available for them to purchase from the conventional mortgage market. The GSEs' market share for single-family owner units was 49 percent, for single family rental properties 13 percent, for small multifamily properties (5-50 units) 2 percent and for large multifamily properties 34 percent. This analysis indicates there is substantial room for growth, particularly in the areas of single-family rental properties and small multifamily properties – properties that traditionally provided significant housing opportunities for low- and moderate- income families.

Fair Lending Review of Automated Underwriting Systems

This past year HUD initiated the first review by Government of Fannie Mae's and Freddie Mac's underwriting and appraisal guidelines. This is a massive and historic undertaking. The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (FHEFSSA) requires HUD to review these guidelines periodically to ensure that the GSEs' do not discriminate and are consistent with the Fair Housing Act and FHEFSSA. Moreover, in light of the importance of the GSEs' underwriting standards and the growth of their automated systems in determining whether many families actually realize the dream of homeownership, this review is timely and essential. Unlike most other areas of

GSE mission regulation for which I have been delegated lead responsibility by the Secretary, primary responsibility for this effort and for Fair Lending regulation of the GSEs is assigned within HUD to the Assistant Secretary for Fair Housing and the General Counsel.

The GSEs' underwriting and appraisal guidelines are the standards that lenders use to determine whether the GSEs will purchase a borrower's mortgage and allow the borrower to receive the most favorable interest rates available in the conventional mortgage market. Within the last five years, both GSEs have separately introduced automated underwriting systems (AUS) that computerize the GSEs' guidelines. Although the GSEs' AUS are relatively new, they are rapidly becoming the prevailing means by which borrowers are approved for conventional conforming mortgages.

While virtually everyone agrees that this new technology is making the process of obtaining home financing faster and possibly cheaper, little is known yet on whether these systems are helping *all* prospective borrowers, particularly minority borrowers, obtain mortgages on favorable terms. Today, minorities are underrepresented in the mortgage market. They are less likely to obtain mortgage financing and less likely to receive loans on as favorable terms as whites. HUD has determined that the GSEs have purchased proportionately fewer loans for African-American and Hispanic borrowers than are originated in the overall private mortgage market. The HUD underwriting review will assess whether Fannie Mae and Freddie Mac are in full compliance with Fair Lending requirements and identify whether it is possible to adapt GSEs' underwriting to expand minority mortgage lending.

Early last year, HUD requested extensive information from both GSEs on how the underwriting systems were developed and how they work, including how their "scorecards" function in deciding which borrowers will be accepted. HUD also requested extensive computerized data on the characteristics of the millions of loans that were processed by the GSEs' automated systems since 1995 in order to examine how borrowers and potential borrowers were actually treated by the systems.

The GSEs have submitted a large volume of information and data in response to HUD's request much of which the GSEs indicate is highly confidential or proprietary business information. HUD expects that it will be able to provide the first results of its review within 6 months, and that it will complete the review by the end of this year.

<u>New Program Reviews</u>

HUD's new program review and approval responsibility is an integral part of the Department's regulatory framework. Considerable resources are being made available within the Department to ensure that new activities are identified, analyzed, and, if appropriate, reviewed as new programs. HUD monitors the GSEs' business activities on an on-going basis and recently requested information on a number of their initiatives

including their mortgage insurance initiatives and their various internet activities which involve the delivery of various mortgage services and products over the internet through a variety of partnerships and joint ventures.

Neither GSE takes the view that these activities constitute "new programs" as defined in current law, and they did not submit them to HUD for approval prior to introducing them in the market. HUD, through its regulatory authority, requested comprehensive information on these activities to determine independently if, in fact, they constitute new programs. This information was recently submitted to HUD by the GSEs and HUD staff are reviewing the material to make these determinations.

Non-Mortgage Investments

The Department increased its oversight activities in the area of non-mortgage investments several years ago. HUD issued an Advance Notice of Proposed Rulemaking on the subject. In addition, the Department now regularly receives and analyzes quarterly reports from Fannie Mae and Freddie Mac on their non-mortgage investment portfolios. HUD also engaged a contractor to study on this issue. The research report will assist the Department by identifying and analyzing various policy options to consider in determining the most appropriate regulatory approach to take with regard to the GSEs' non-mortgage investments. HUD expects to receive the final report very shortly and will actively analyze and consider its findings.

Availability of Public Information on GSE Activities

Educating the public about the GSE activities in order to assist the public in evaluating those activities is another area regulatory responsibility that HUD actively carries out. Each year since 1993, HUD has released a public use data base containing loan level information on Fannie Mae's and Freddie Mac's mortgage purchases. The March 9 proposed affordable housing goals rule also contains certain rule changes in the classification of the GSEs' mortgage data. These changes would classify data in a manner more compatible with loan information reported by primary lenders under the Home Mortgage Disclosure Act (HMDA). Greater consistency between these two important data sources will increase the comparability and therefore, the usefulness of the GSE public use data base.

In addition, HUD recently determined that certain cross tabulations of GSE data are not proprietary even if they were aggregated from loan level elements that are identified as proprietary. HUD believes that when certain information is aggregated at national and certain regional levels it loses its proprietary characteristics and should be made available publicly. HUD is continuing to identify whether certain other aggregations of data should be made publicly available.

OFHEO's Risk-Based Capital Rules

The Office of Federal Housing Enterprises Oversight (OFHEO) functions as an independent office within HUD. As the safety and soundness regulator for the GSEs, OFHEO was mandated by Congress to develop a risk based capital rule for Fannie Mae and Freddie Mac. OFHEO's proposed rule described a comprehensive model to use for determining the appropriate level of capital the GSEs must hold. The comment period for the proposed rule ended earlier this month and we expect that a final rule will be published within the next year.

EXISTING STRUCTURE WORKS WELL

The existing regulatory structure governing Fannie Mae and Freddie Mac –which separates the mission and safety and soundness regulatory functions but creates mechanisms for consultation and coordination -- allows for a careful balancing of public policy needs with legitimate safety and soundness considerations. Congress understood this in 1992 when it created the Office of Federal Housing Enterprise Oversight or OFHEO, as an independent agency of HUD responsible for the safety and soundness of the enterprises and charged the HUD Secretary with mission oversight. At the same time, we recognize that for the long haul, revisions to the existing regulatory structure may be necessary to keep pace with changing market conditions.

By placing regulation of Fannie Mae and Freddie Mac under the jurisdiction of HUD, Congress recognized that this significant regulatory function merited cabinet level emphasis that would ensure that there was an integrated and coordinated housing policy for the nation. At the same time, OFHEO's role as the safety and soundness regulator was designed to be sensitive to the GSEs' critical housing missions. While OFHEO was designed to be independent, Congress recognized the importance of OFHEO maintaining a link with HUD to ensure that the safety and soundness regulation interfaced with the GSEs' programmatic missions.

After seven years of experience, we can affirm that the current structure between HUD and OFHEO is working, as intended by Congress. HUD and OFHEO frequently communicate on issues of common interest. Most recently, the two organizations worked closely to ensure that the two proposed rules issued recently by HUD and OFHEO – the affordable housing goals and the risk-based capital requirement –were consistent and coordinated.

With regard to the Federal Housing Finance Board, I am the Secretary's Representative on the Finance Board. I am in contact with staff or other Finance Board members regularly. The overlap in my responsibility on the Finance Board with my responsibility for regulating the mission of Fannie Mae and Freddie Mac allows for the Administration to have critical input on housing policy issues of the Finance Board and

allows for coordination of mission oversight activities between both agencies where appropriate.

HOUSING FINANCE REGULATORY IMPROVEMENT ACT – H.R. 3703

H.R. 3703 includes a number of helpful elements for GSE regulation that are worthy of careful consideration. HUD Secretary Cuomo and I look forward to working with the Chairman and the Committee to make needed improvements in mission regulation that will further the GSEs' public purposes. Three items in the bill that would strengthen HUD's mission oversight are those that provide for (1) authority to assess the GSEs for the cost of regulation including mission regulation outside of the appropriations process; (2) strengthened authority to review new program activities; and (3) additional legislative direction for limiting non-mortgage investments.

Assessing the GSEs for the Cost of Regulation (Sec. 105)

HUD supports the principle that the GSEs' should pay for the full cost of their regulation including mission regulation.

It is important to recognize that Congress gave HUD specific responsibilities for mission oversight of Fannie Mae and Freddie Mac that are separate from the other areas of the Department's responsibilities with regard to housing. For example, the fair lending provisions of the GSE Act go beyond the standard enforcement of the Fair Housing Act. Adequate resources need to be devoted to mission oversight if it is to be fully effective.

New Program Review Authority (Sec. 110)

The Department also supports the principle of strengthening and clarifying the approval authority for new activities of the enterprises. The Secretary currently has authority to review new programs of the GSEs under its new program authority and ongoing activities of the GSEs under the Department's general regulatory authority. But unquestionably, the provisions in this section would further clarify these authorities and change the standard for review by requiring the regulator to affirmatively conclude that the GSE activities are in the public interest.

Even so, this provision may be too limited since it does not expressly permit the regulator to review activities except those that are connected, or related, to mortgages. For example, the proposal does not address instances where the GSEs pursue new diverse activities that are asserted by the GSEs to fall within their existing charter authority to invest. While these activities are addressed under the Government's current general regulatory authority, H.R. 3703 does not expressly authorize the regulator to review such activities.

HUD reserves judgment on the advisability of Federal Register public notice of proposed new activities. While providing interested parties with an opportunity to comment, we have some concerns that the procedure may be too unwieldy and/or tend to stifle innovations in the mortgage market.

Non-Mortgage Investments (Sec. 111)

HUD believes it currently has regulatory authority over the GSEs' non-mortgage investments but welcomes clearer direction from Congress on its responsibilities and enforcement powers in this area. Some express limitation on non-mortgage investments may be appropriate to ensure that GSEs do not take advantage of their GSE status and that they further their public purposes.

Fair Lending Oversight (Sec. 109)

In addition, the Department believes that its fair lending responsibilities with regard to the GSEs are significant and unique in that there is no other regulator assessing the GSEs' fair lending practices. With other financial institutions, banking regulators conduct fair lending reviews as part of compliance examinations. Fannie Mae and Freddie Mac scrutiny comes from HUD. Given the significant role the GSEs play in the mortgage market, it is important that their underwriting practices are reviewed to ensure that they are consistent with the fair lending laws.

For this reason, it is critical that the current fair lending enforcement authority governing the GSEs not be weakened. As we read H.R. 3703, responsibility for the fair lending provisions contained in FHEFSSA would be retained by HUD, but the power to enforce this responsibility, which currently resides with OFHEO, would be transferred to the new entity. Such a provision fragments fair lending responsibility for the GSEs and thereby hampers the Government's ability to carry out this critical function.

OTHER MATTERS WORTHY OF CONSIDERATION

With regard to the provisions of H.R. 3703 that govern the elimination of the GSEs' line of credit with the U.S. Treasury, the conforming loan limit governing the upper limit on the mortgages the GSEs can purchase, and the release of information on the GSEs activities, the Department does not take a specific position but raises several issues for consideration.

Treasury Line of Credit (Sec. 136)

As part of their Congressional Charters, the two enterprises, receive significant benefits that are not enjoyed by any other shareholder-owned corporations in the mortgage market. These benefits include access to the $2.25 billion line of credit from the U.S. Treasury, exemption from the securities registration requirements of the

Securities and Exchange Commission and exemption from all State and local taxes except property taxes. These benefits, conferred upon the GSEs by Congress, lead the markets to provide the GSEs with advantages over wholly private companies. Consequently, all of these benefits need to be reviewed regularly to determine their value and continued need. We defer to the Treasury Department's testimony on whether repeal of the line of credit would be consistent with the GSEs' Congressional status.

Release of Information (Sec. 103)

H.R. 3703 provides that the new board will make available information to the public on the GSEs. Increased light on the GSEs' activities and financial position is helpful. Given their status as GSEs and their market dominance, Fannie Mae and Freddie Mac should be subject to a higher standard when it comes to the release of such information. More expansive and detailed information will allow the public to independently determine the benefits of public sponsorship.

At the same time, the need for broad public disclosure must be carefully weighed against the GSEs' concerns about protecting proprietary or trade secrets, the release of which could have a negative impact on their business operations and their financial condition. HUD now has extensive experience in working with the GSEs on these matters and would be pleased to work with the Committee to draft language that expands public access to GSE information while at the same time protecting legitimate proprietary interests.

Conforming Loan Limit (Sec. 112)

This provision governing the determination of the conforming loan limit that establishes the upper limit on the dollar amount of an individual mortgage a GSE may purchase appear to leave an ambiguity that has presented a problem in the past. The conforming loan limit language does not appear to adjust for decreases as well as increases.

Safety and Soundness Provisions

The provisions in the bill that address safety and soundness related areas, such as the broader stress test authority, certain supervisory actions, the use of ratings agencies and the appointment of receivers are matters within the responsibility of OFHEO. We, therefore, defer to OFHEO's and the Treasury Department's testimony on these topics.

CONCLUSION

In summary, HUD believes that it is a strong and effective regulator ensuring that the regulatory responsibilities assigned to it under current law are carried out prudently. The current regulatory structure is working well and is having a valuable impact on affordable housing markets. But, there is more, much, much more that can and must be done. There is a crisis in need for affordable housing and the need is growing not diminishing. There are actions Congress can and should take to make HUD's mission oversight more effective that will allow Americans to receive the full benefit of Fannie Mae's and Freddie Mac's government sponsorship.

STATEMENT OF

THE HONORABLE ARMANDO FALCON, JR.
DIRECTOR, OFFICE OF FEDERAL HOUSING
ENTERPRISE OVERSIGHT

REGARDING H.R. 3703, THE HOUSING FINANCE
REGULATORY IMPROVEMENT ACT

BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES
AND
GOVERNMENT-SPONSORED ENTERPRISES

U.S. HOUSE OF REPRESENTATIVES

MARCH 22, 2000

STATEMENT OF
THE HONORABLE ARMANDO FALCON, JR.
DIRECTOR, OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT
BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES AND GOVERNMENT-SPONSORED ENTERPRISES
U.S. HOUSE OF REPRESENTATIVES
MARCH 22, 2000

Mr. Chairman, Representative Kanjorski, and Members of the Subcommittee, I appreciate the opportunity to appear before you today to discuss H.R. 3703, the Housing Finance Regulatory Improvement Act. The bill takes a two-track approach at improving the regulation of government sponsored enterprises (GSEs). One track is consolidating the regulation of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks into a new independent agency. The other track makes a number of amendments to the GSEs' charters addressing safety, soundness and systemic risk issues.

Mr. Chairman, first I want to commend you for your ongoing commitment to ensuring the best possible oversight of the GSEs and reiterate my support to achieving this end. You and Representative Kanjorski have brought real leadership to GSE issues in general and I look forward to working with you and your colleagues on the full Committee to ensure the best possible oversight structure.

As you know, since OFHEO began operating in 1993, Fannie Mae and Freddie Mac have doubled in size. The Enterprises' exposure to credit risk has doubled to over $2 trillion. The bulk of this growth has occurred in their retained portfolio of mortgages and mortgage-backed securities, which grew by over 350 percent. The amount of mortgage assets on which they manage interest rate risk now exceeds $846 billion. The need for strong oversight is more critical now than ever before.

As Congress considers the changes you have proposed, I want to assure you that there is a very strong regulatory system already in place. OFHEO works well as the safety and soundness regulator for Fannie Mae and Freddie Mac (the Enterprises). The only shortcoming, which I will address later in my testimony, is OFHEO's lack of financial independence.

OFHEO's top-notch examination program is an annual comprehensive, risk-based assessment of the health and management of the Enterprises. We recently completed our 1999 examinations of the Enterprises and will be reporting our results and conclusions to their respective Boards in the near future. The results and conclusions of these

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The views expressed herein are my own and do not necessarily represent the views of the Secretary of Housing and Urban Development or the President. The Office of Federal Housing Enterprise Oversight (OFHEO) is an independent office within the Department of Housing and Urban Development (HUD) charged with ensuring the safety and soundness of Fannie Mae and Freddie Mac (the Enterprises).

examinations will also be communicated to Congress in June in OFHEO's Annual Report.

Also, as I'm sure you are aware, the comment period on our risk-based capital proposal closed on March 10 and we are currently in a "comment on comment process" that will end in April. It is my intention to move expeditiously to a final risk-based capital rule that will truly be state-of-the-art. In the end, the rule will be dynamic so that it can evolve over time to reflect new products, innovations in risk management, and new techniques for measuring risk. This will provide the Enterprises with the flexibility to operate their businesses while closely matching capital to risk.

In order to understand how changes in the market impact the Enterprises and how changes in Enterprise operations impact the market, OFHEO also conducts sound and authoritative research and analysis. The information and insights gained from our research and analysis shop helps OFHEO -- and Congress -- become even more proactive in its oversight of the Enterprises. This is critical given today's rapidly changing markets.

Mr. Chairman, while the current system is working well, that doesn't mean it can't be improved. Consolidation of the safety and soundness regulation of the housing GSEs could lead to even stronger oversight, if done right. However, the consolidation of mission regulation with safety and soundness regulation is not essential for OFHEO or its successor to properly fulfill its safety and soundness responsibility. Any need OFHEO may have to be aware of developments in mission regulation is satisfied through the open lines of communication that exists between OFHEO and HUD. For example, OFHEO was fully consulted on the development of HUD's affordable housing rule regarding the safety and soundness implication of the new goals.

Nor has mission regulation suffered. Secretary Cuomo and Assistant Secretary Apgar have demonstrated their strong commitment to fulfilling HUD's mission oversight responsibility. I have several general comments to make on H.R. 3703. In addition, as the bill moves forward in the process, I will be happy to provide the Subcommittee with whatever technical assistance it needs.

Strong and Independent Safety and Soundness Oversight

The structure and authorities of the regulator created under H.R. 3703 would maintain and, in some ways, even improve the existing strong and independent regulatory framework for safety and soundness oversight of Fannie Mae and Freddie Mac. This is ever more important, given the continued rapid growth of the Enterprises.

I am fully supportive of increasing the transparency of the Enterprises' operations to the public. More disclosure would serve to increase the efficiency of the secondary mortgage market. In addition, more complete and timely disclosure about the Enterprises' activities and risk exposures would also help to strengthen the ability of the market to better evaluate and price the Enterprises' securities.

OFHEO already contributes to this process by disclosing the results and conclusions of our comprehensive risk-based examinations. And while I recognize the need to protect proprietary Enterprise data from public disclosure, OFHEO will be looking for additional ways to increase the public's understanding of the Enterprises' activities and risk exposures.

Consistent with this approach, the bill would require the regulator to obtain annual credit ratings for the Enterprises from nationally recognized statistical rating organizations. OFHEO exercised its existing authority to obtain such a rating in 1996. With adequate funding, regular updates of this type would provide more information to investors about the Enterprises' financial condition and would provide an additional source of information about the Enterprises' financial condition to the regulator.

The bill also reflects prudent public policy by providing for the appointment of a receiver for a GSE under certain circumstances, which is an important option for a regulator and one that does not exist in current law. Under some dire circumstances, receivership may be the most cost-effective and efficient resolution of an Enterprise's problems. Furthermore, the absence of such provisions serves to weaken market discipline by reinforcing the market's conviction that Enterprise securities are implicitly guaranteed by the government.

Finally, I am fully supportive of a transparent regulator. The regulator should report on all of its actions to Congress and to the public, and should be held accountable for its actions. Having comprehensive reporting requirements provides a means for Congress to have effective oversight of the regulator's activities. It also provides meaningful discipline to the regulator in the execution of its oversight responsibilities.

Now I would like to address the regulatory structure contained in the bill.

Board Structure

The bill consolidates the current safety and soundness and mission regulatory responsibilities of OFHEO, HUD, and the Federal Housing Finance Board into a new, independent agency. The new agency will be managed by a five-member Board comprised of a Chairman, two full-time Directors, and the Secretaries of Treasury and HUD.

Mr. Chairman, I believe that a single agency head is preferable to a Board. It is not unprecedented for independent agencies to be headed by a single individual. There are many examples of this structure, including the National Aeronautics and Space Administration (NASA) and the Environmental Protection Agency (EPA). This structure has proven to be effective and efficient.

First, a single agency head focuses accountability on one individual, rather than diffusing accountability among numerous Board members. Second, a single agency head

unifies day-to-day management of the agency in one person, which avoids the confusion, dissension, and gridlock often associated with Boards. Also, a single agency head allows the agency to move nimbly in reacting to the risks of the companies it regulates.

Transition and Effective Date

Whatever Congress decides on the final structure of the new agency, I know you will agree that the bill should do everything possible to ensure success of the new agency.

To that end, I strongly believe that the bill's transition period needs amending. First, the 9-month period is far too short. Also, under the bill, until at least two members of the new Board are confirmed, authority is vested jointly in Treasury and HUD. This seems inconsistent with the intent of providing further independence.

I recommend that the bill include a longer, more practical transition period. During this transition period, the duties and functions of the existing agencies would be combined into one agency, allowing the integration of the agencies before the new agency assumes responsibility. This is especially crucial if the new agency is set up under a Board structure, because it would allow the new Board to inherit a fully integrated agency, rather than having to grapple with integration while also learning how to work together.

A longer transition period will also allow OFHEO and the Federal Housing Finance Board to conclude the major regulations which are already in process.

Finally, this longer transition would accommodate a more orderly merging of the technological and regulatory infrastructures of the three current agencies.

Agency Funding

Mr. Chairman, as you know, we share a view that safety and soundness regulators need to be free of the uncertainty of the annual appropriations process and have the flexibility to set resources in response to any rapid changes in the GSEs or the market. That is why I wholeheartedly and enthusiastically support the bill's funding mechanism.

I feel very strongly that the current situation of subjecting OFHEO to the appropriations process is bad public policy. That is why I have asked Congress to remove OFHEO from the annual process. This would put us on par with other safety and soundness regulators such as the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Housing Finance Board, the Federal Reserve Board and the National Credit Union Administration.

I want to be clear that this change would in no way remove OFHEO from appropriate congressional oversight. OFHEO would continue to be subject to the oversight of this Committee and would still have to meet all annual statutory reporting requirements. Removing OFHEO would simply provide me with the flexibility I need to

respond quickly to changing conditions, especially a deteriorating one, of the Enterprises or the market.

I want to thank you for your support of our previous budget requests. I also want to thank you for taking the lead on the appropriations issue. I hope that our combined efforts will achieve this goal this session.

Conclusion

Mr. Chairman, I want to thank you again for the opportunity to testify this morning. As I stated in my testimony, the current regulatory system is working well, but that does not mean that improvements can't be made. I am committed to working with Congress to ensure that the system for regulating the GSEs is as strong as possible.

Statement of Bruce Morrison

Chairman

of the

Federal Housing Finance Board

before the

Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises

of the

Committee of Banking and Financial Services

of the

U.S. House of Representatives

regarding

H.R. 3703

The Housing Finance Regulatory Improvement Act of 2000

Washington, DC
March 22, 2000

I. Introduction.

Good morning Mr. Chairman, and members of the subcommittee. I would like to thank you for the opportunity to appear today to testify on the Housing Finance Regulatory Improvement Act of 2000 (H.R. 3703). I should point out that the Board of Directors of the Finance Board has not reviewed my testimony and it does not represent the Administration's view or position.

I would like to preface my comments by commending you, Mr. Chairman, and Chairman Leach for your work on this legislation that embodies the concept of a single housing-finance GSE regulator. I would also like to thank Mr. Baker and Mr. Kanjorski, as well as Mr. Leach and Mr. LaFalce for the vote of confidence they gave the Federal Home Loan Bank System with their leadership in the passage of the Federal Home Loan Bank Modernization Act as part of the Gramm-Leach-Bliley legislation in October. The legislation effectively ends the debate about the viability of the FHLBank System and gives it the structure and tools for the new century.

The small-bank provisions in particular will greatly increase access to FHLBank liquidity for these institutions, and allow Main Street institutions the chance to compete with Wall Street institutions, and to serve their communities more effectively.

Let me now return to H.R. 3703. The issue of consolidating the regulators of the housing-finance GSEs was before this subcommittee most recently in July 1997. At that time, I testified that I agreed with the underlying premise of the legislation: that a single independent

agency regulating safety and soundness and mission for Fannie Mae, Freddie Mac, and the Federal Home Loan Banks is preferable to the current structure. Since my views are substantially unchanged, I have attached a copy of my testimony previously delivered to this Subcommittee on July 24, 1997. My further comments presented here will expand upon those views and discuss provisions specific to H.R. 3703.

II. Effective Mission Regulation is Central to GSE Oversight.

Congress long ago decided that promoting homeownership is desirable and worth the cost of granting special advantages to homebuyers, such as the mortgage interest tax deduction, and the establishment of specially advantaged GSEs to facilitate housing finance and other socially desirable activities. In exchange for public support, the American taxpayer has the right to expect responsible behavior by the GSEs. It is obvious that it is critically important to protect the taxpayer from potential loss by monitoring and regulating GSE financial risk. It is also critically important to ensure that the low cost-of-funds and other advantages entrusted to the GSEs are well directed and ultimately reach their intended beneficiaries. There is a risk that much of the government's benefit is absorbed as profits in the GSE conduit. Mission regulation ensures that this valuable GSE benefit passes through to its rightful beneficiaries and makes the difference between helping consumers and enabling corporate welfare.

GSEs are created to accomplish statutorily prescribed missions and are provided with advantages, including state and local corporate tax exemptions and a U. S. Treasury line of credit, which taken together produce lower cost of funds and operations. It is up to the regulator

to ensure a public benefit at the rightful price for that lower cost and to enforce the mission prescribed by Congress.

Mission regulation and safety and soundness regulation are closely related. H.R. 3703 recognizes this by giving the new board authority to limit nonmission-related assets. Many assets are perfectly safe and sound from a financial point of view. But, because the GSEs were created for very specific purposes, only some assets are consistent with the mission of those GSEs. A GSE may be less profitable if certain assets are prohibited and this could have safety and soundness consequences. A combined safety and soundness and mission regulator can weigh the tradeoffs between profit and mission suitability to determine the proper policy much more safely and efficiently than can two separate regulators where the responsibilities for safety and soundness and mission are housed in different agencies.

Some in the GSE community believe that mission regulation should be left entirely to congressional oversight, but I believe that is unworkable. As much as we would like statutes to unambiguously prescribe behavior in every circumstance, the reality is that financial sector regulators face questions of statutory interpretation on an almost daily basis. Legislation alone can never be nimble enough to handle the day-to-day realities of regulating multi-billion dollar businesses.

Additionally, the best way to ensure that the GSE benefit is passed through to consumers is to create a structure where market competition forces the distribution of subsidy through the GSE conduit. A single regulator for the housing GSEs would facilitate this by creating a level

playing field for the three GSEs and by design create equalizers such as competitive capital levels and competitive product authorizations. H.R. 3703 allows for this by specifying a common new activity approval process for the three GSEs.

I recommend the FHFB's pilot approval process as a model. Starting in mid-1995, the Finance Board encouraged the FHLBanks to engage in activities aimed at improving housing finance and community lending opportunities in their respective districts through limited scale, and therefore limited risk, pilot programs. The most visible success resulting from this initiative is the Mortgage Partnership Finance (MPF) product developed by the FHLBank of Chicago. The Finance Board's role was to ensure oversight of safety and soundness, legality, and mission suitability, and to require appropriate control, regulatory review, and examination procedures at all stages of development.

III. GSE Oversight Requires Independence in its Regulator.

Regardless of the particular structure of GSE regulation, certain characteristics are crucial if independent regulatory judgments are to be made. H.R. 3703 contains some improvements in this area, but could do more.

The proposed legislation removes the Office of Federal Housing Enterprise and Oversight from the appropriations process. I fully endorse this provision. OFHEO is dependent on Congress to set the formula for its funding, a process that could prevent the agency from

responding rapidly to emerging problems, and limits its flexibility and resources in ensuring that Fannie Mae and Freddie Mac are operated safely under changing economic scenarios.

The proposed legislation also calls for the President to designate an appointed director to serve as chairperson of the board, with this privilege expiring with a change of administrations. I would favor a provision to allow the chairman to be nominated by the President and confirmed by the Senate as chairperson for the duration of his or her term. Such a provision would increase the independence and credibility of the new board and add prestige to the position, which would, I think, result in more effective regulation of the GSEs.

I also recommend expanding the board from five to seven members. The Administration is amply represented by HUD and Treasury. An expanded board would allow for a more diversified view and a wider range of expertise. The positions other than the Chairman should be part-time. This not only saves money in salaries, but it also encourages more prominent and experienced individuals to accept these positions than would normally be the case given the sacrifices of full-time government service.

IV. Avoid Raising GSE Costs Without Benefit.

Some aspects of H.R. 3703 acknowledge the reality that the government has created special GSE benefits which must be safely administered and directed toward public benefit. Other provisions seem intended to reduce the benefit, but do not achieve any real reduction in public sector risk. Such changes impose costs without real benefits.

H.R. 3703 would eliminate the so-called "superlien" that is granted by statute to the FHLBanks. I believe this would impose a cost on the FHLBanks which could raise prices to members with no real benefit.

The superlien was created by Congress under the Competitive Equality of Banking Act of 1987. This provided that any security interest granted by a member to a FHLBank would be entitled to priority over the claims and rights of any other party, including the Federal Deposit Insurance Corporation (FDIC) as a receiver or conservator. The only exception is with regard to claims of other creditors of a member that have been secured by a more senior perfected security interest. Prior to 1987, the FHLBanks could achieve the same priority status by perfecting their security interest in specific assets of the member, but doing so would have been time consuming, cumbersome, and expensive. But since the FHLBanks and the insurer of most of their members, the Federal Savings and Loan Insurance Corporation (FSLIC), were both under the control of the Federal Home Loan Bank Board, there was little concern over competition between the two in liquidations.

If the superlien were eliminated, the FHLBanks would be forced to perfect their security interests on an asset-by-asset basis rather than using a "blanket lien" as they do for most of their lending today. The expense of this process would not result in any benefit to the FDIC insurance funds, because the perfected security interests of the FHLBanks still would be entitled to a priority over the claims of other creditors, including those of the FDIC.

As deposits are disintermediated from banking institutions to the capital markets, FHLBank advances serve to recapture those funds and return them to local use. It would seem that a member bank's use of safe and nonvolatile FHLBank advances would be preferable to relying on brokered deposits and other sources of "hot money" that caused the industry and the taxpayer so much grief in the past. Borrowing from the FHLBanks should remain as efficient and inexpensive as possible.

The proposed legislation also would eliminate the lines-of-credit the GSEs have with the U. S. Treasury. This, I believe, would send a wrong message to purchasers of GSE debt. Granted, the $4 billion FHLBank System line of credit is insignificant when viewed in the context of the $500+ billion in outstanding obligations of the System. But, the line-of-credit now exists and it contributes to the lower funding costs supplied by capital market pricing of FHLBank System consolidated obligations. Removal of the line-of-credit could adversely affect these costs with no reciprocal reduction in government exposure. These increased costs will raise the prices of FHLBank products.

That concludes my testimony for today. I will be happy to answer any questions you may have. Thank you.

Statement of Bruce A. Morrison

Chairman

of the

Federal Housing Finance Board

before the

Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises

of the

Committee on Banking and Financial Services

of the

U.S. House of Representatives

regarding the

Report of the General Accounting Office

on

Creating a Single GSE Regulator

Washington, D.C.
July 24, 1997

Good morning Mr. Chairman, Congressman Kanjorski and other Members of the Subcommittee. My name is Bruce A. Morrison, and I am Chairman of the Federal Housing Finance Board. I welcome the opportunity to appear before you today to testify regarding the recent report of the General Accounting Office on the advantages and disadvantages of creating a single housing GSE regulator. Please note that the views I express will be my own; this statement has not been reviewed by the Board of Directors of the Finance Board. It does not represent a statement of Administration position or views.

At the outset, I wish to thank all of you for your support of the Federal Home Loan Bank Act amendments that are included in the Financial Services Competition Act of 1997, H.R. 10. In particular, I warmly and strongly commend Chairman Baker and Mr. Kanjorski for their leadership and skill in developing and successfully advocating the adoption of these amendments. The Federal Home Loan Bank System is financially strong and has a long and positive track record of service to its members and the communities they serve. However, like other financial services providers, the System needs to adapt to changing conditions. The amendments address the need for a strengthened capital structure, make membership fully voluntary, remove the regulator from inappropriate involvement in the Bank governance process, rationalize the REFCORP burden, and recognize the usefulness and appropriateness of a broader Bank System as a wholesale funding mechanism for community banks. The amendments, if enacted, would empower the FHLBanks to be active and effective in meeting community credit needs in the next century.

Turning to the GAO report, I wish first to note that, in my view, it is always timely for Congress to review Executive Branch structures in an effort to achieve cost savings and operational efficiencies. Such reviews certainly should not be confined to times of crisis. Indeed, the fact that there currently is no significant problem, much less any crisis, affecting the regulation of the housing GSEs should contribute to a more measured approach to evaluating the merits of the consolidation being proposed.

Conceptually, I am in accord with the premise of the GAO report that a single independent agency regulating safety and soundness and mission for Fannie Mae, Freddie Mac and the FHLBanks is preferable to the current structure. And, it is likely that some cost savings ultimately could be realized through such an agency consolidation as redundant positions were eliminated. We have not attempted to quantify such possible savings, but I expect they would be modest, given the small size of the existing agencies. As the report correctly notes, there would be some transitional costs associated with a merger, as well as some operational disruption stemming from the general employee anxiety accompanying such situations, and the need for internal restructuring. I doubt the transitional cost or disruption would be significant.

The central question for this Committee to consider is whether consolidation will yield more effective regulation. I believe that the answer is "yes". Regulatory effectiveness would be enhanced at a number of different levels. The consolidated agency's larger mission would make it a more interesting place for employees, thus helping to attract and retain high-quality

professionals. It would bring the agency a broader working knowledge of the mortgage finance marketplace that is the foundation of the operations of the housing GSEs and their members and customers. Most importantly, as GAO points out, the broader mix of competitive entities to be regulated would enhance the independence of the oversight process, particularly in evaluating the competitive effects of regulatory decisions, and assure, to the extent possible, more evenhanded regulatory treatment. The net result should be more effective, consistent regulation.

As a structural matter, I believe GAO outlines precisely the right approach to take in advocating the unification of regulatory responsibilities for ensuring both mission compliance and safety and soundness of the regulated entities. My experience at the Finance Board has convinced me that a unified mission and safety and soundness regime offers the most appropriate way to administer a regulatory framework. A bifurcated approach necessarily will require greater staffing levels and more expense without any assurance that it will yield improved results. In circumstances where there is no conflict between safety and soundness and mission regulation, there is no reason to place responsibility for them in separate places. Where there is a conflict, separation only invites making the balancing of the two policy objectives more awkward and less precise. Instead of one Board or Administrator, who is thoroughly familiar with the competing priorities, making a balanced judgment, the conflict must be negotiated between regulators, offering the regulated entities the opportunity to play one regulator off against the other.

Before leaving this point, let me stress my conviction that it is entirely necessary and appropriate for the regulator of a government sponsored enterprise to oversee that GSE's mission

compliance GSEs are created to accomplish statutory prescribed purposes and are provided with special privileges, such as tax exemptions and a U S Treasury line of credit, that create an implied federal government backing for their obligations In extending these benefits, it has been standard Congressional practice to authorize each GSE's regulator to make sure that the regulated institution is doing what it was created to do That this is as it should be may seem entirely clear to you, but I note from the GAO report that some in the GSE community believe that mission regulation should be left entirely to Congressional oversight, a wholly inappropriate structure except to those seeking to minimize their public obligations

Some claim that regulatory bifurcation comes to us as a lesson of the thrift crisis. If so, it is a lesson that has been very unevenly applied, as all the federal banking regulators, including the Office of Thrift Supervision, have important mission responsibilities -- extending beyond chartering to Community Reinvestment Act and consumer disclosure compliance matters -- as well as safety and soundness duties. In fact, I suggest that the real structural lesson of the thrift debacle is that the job of administering federal deposit insurance is sufficiently large and important that it should remain independent from unrelated regulatory duties. I find unsupportable the thesis that the events leading to the thrift crisis point to the need for a bifurcated, OFHEO/HUD-style approach to GSE regulation It would be unfortunate if one of the ultimate negative consequences of the thrift crisis were mistaken lessons leading to inappropriate regulatory structures.

GAO in my view is correct on the issue of independence. In the case of the housing GSEs, independence would be a considerable virtue. The regulated entities in question are

economically and politically powerful organizations that can be expected to make unusually strong, continuing efforts to affect their regulatory treatment. Placing responsibility for their oversight in an independent agency offers the regulator important insulation from political pressures, while offering Administration policymakers some detachment from controversies which otherwise would invite trade-offs with other concerns and priorities.

I agree with GAO on the general point that independent, arms-length regulation requires a structure where business governance is fully delegated to the regulated entities. In the case of the FHLBank System, the Finance Board already is delegating these matters to the extent allowable by statute. I have already mentioned that H.R. 10 would complete this job by fully removing the Finance Board from governance as opposed to regulatory issues.

While I thus agree with GAO on the need to distinguish between regulation and business governance, I disagree with GAO's assertion that the Finance Board's appointment of the public interest directors of the FHLBanks compromises this agency's ability to be an arms-length regulator of the Banks. This is a highly theoretical point. In practice, there simply is no instance of which I am aware of the Finance Board or its predecessor seeking to steer the management direction of the Banks through selection of public interest directors. Frankly, the rulemaking and supervisory processes would offer the regulator a vastly easier and more effective way to influence Bank policy than would the appointment of public interest directors, who enjoy four year terms (often outlasting the terms of the appointing Finance Board members) and can be dismissed only for cause. Public interest directors are an appropriate feature for a GSE, and I

believe there is great merit in keeping their appointment at the regulator level, as the regulator has a strong, overriding interest in identifying and selecting individuals with backgrounds and personalities that will add real strength to the boards of the Banks. Presidential appointment exchanges theoretical independence for the intrusion of political considerations wholly unconnected to enhancing the public interest perspective on the boards.

Mr. Chairman, this concludes my remarks. I will be happy to answer any questions you may have.

Thank you.

STATEMENT OF J. TIMOTHY O'NEILL DIRECTOR, FEDERAL HOUSING FINANCE BOARD

FOR THE RECORD OF THE HEARING ON THE "HOUSING FINANCE REGULATORY IMPROVEMENT ACT OF 2000"

BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES AND GOVERNMENT SPONSORED ENTERPRISES OF THE U.S. HOUSE OF REPRESENTATIVES COMMITTEE ON BANKING AND FINANCIAL SERVICES

MARCH 22, 2000

Thank you, Mr. Chairman, and Chairman Leach and other members of the Subcommittee for allowing me, as one of three Directors of the Federal Housing Finance Board, this opportunity to offer my comments on the "Housing Finance Regulatory Improvement Act of 2000". My comments are my own, and not that of the other members of the Federal Housing Finance Board.

For the reasons listed in my testimony before this subcommittee on July 24, 1997, a persuasive argument can be made to allow the two housing-related government sponsored enterprises to continue to exist as separate entities. Those two reasons were: 1) the mission and safety and soundness of the Federal Home Loan Bank System are currently well-regulated together by the Federal Housing Finance Board. The System has not experienced a credit loss since its creation in 1932, and the System continues to successfully meet its public purpose. In other words, as I stated in my prior testimony, "if it isn't broken, don't fix it." 2) Creating a single government sponsored enterprise violates the GAO criterion of the separation of the primary and secondary market

regulation. Keeping the oversight of these public missions separate is a healthy policy to maintain for effective regulation.

In addition, another reason to allow the entities to exist separately is found in their inherent differences. The secondary markets are centralized in nature while the Federal Home Loan Bank System is entirely decentralized with its 7,000 members throughout the United States. To try to regulate two such different bodies – the secondary market/centralized entities and a primary market/decentralized entity – under one regulator may be counterproductive.

If, however, the U.S. Congress decides to consolidate the housing-related government sponsored enterprises under the Housing Finance Regulatory Improvement Act of 2000, the following are my concerns:

1) If enacted, Section 101 which establishes a 5 full-time member board, including the Secretary of HUD and the Secretary of the Treasury – – could end 67 years of independence for the regulator of the Federal Home Loan Bank System. Given the System's glorious history through some rather tumultuous times, I think the regulator's independence from the Administration has served the United States well. I strongly feel that having three out of five Board Members who are not private citizens impairs the mandated independence of the Board. I prefer the status quo that allows for a Board independent of the Administration, especially since safety and soundness are not, and should not be partisan issues.

2) If enacted, Section 111 which establishes a limitation on non-mission related assets – – could pose serious problems for the liquidity and the membership of the System during an economic downturn. Care must be taken not to straightjacket

the FHLBanks in the belief that the current economic prosperity will continue indefinitely. Section 111, as written, does not provide flexibility for the Federal Home Loan Banks to maintain liquidity in the event of an economic crisis.

3) If enacted, Section 138 which eliminates the super-lien priority for the Federal Home Loan Banks over the assets of a member financial institution that fails -- could pose serious problems for the Federal Home Loan Bank System. Care must be taken not to destabilize the Federal Home Loan Bank System while removing the super-lien.

In conclusion, I believe the current method of separately regulating the housing-related government sponsored enterprises has fared well for the Federal Home Loan Bank System, a system that continues to successfully meet its public purpose without ever having incurred a credit loss. Maintaining separate oversight of a primary market/de-centralized entity such as the Federal Home Loan Bank System from the oversight of the secondary market/centralized entities of Fannie Mae and Freddie Mac is a healthy policy for effective regulation. If, however, the U.S. Congress should decide otherwise and the Housing Finance Regulatory Act of 2000 becomes law, it is my hope that the Act better addresses the three above-listed concerns.

APPENDIX

May 16, 2000

CURRENCY

Subcommittee on Capital Markets

Richard Baker, Chairman

For Immediate Release: Tuesday, May 16, 2000
Contact: Brookly McLaughlin at (202) 226-0471 or Michael Diresto (202) 225-3901

Opening Statement of
Representative Richard H. Baker
Chairman, Subcommittee on Capital Markets, Securities and
Government Sponsored Enterprises
Housing Finance Regulatory Improvement Act (H.R. 3703)
May 16, 2000

On behalf of the Subcommittee, I would like to welcome Chairman Raines, Chairman Brendsel, and Chairman Hage and express my appreciation for their appearing before us today. Because I am cognizant of each of the chairmen's valuable time, and because I hope to allow for sufficient time for questions, I have requested limitations on all opening statements, and hence will quickly outline my objectives in calling this hearing.

Before I begin, I believe it is essential for me, in light of increased media attention of late regarding this legislation, to stress that the intent of the bill is no way dependent upon personal matters; it should be common knowledge that I have the utmost respect for the professionalism of each of the housing GSE chairmen, and I trust that by working within an atmosphere of mutual respect we may all further our understanding of these complex issues.

I would add, with equal importance, that I have always been and continue to be completely supportive of the mission that Fannie Mae, Freddie Mac, and the Federal Home Loan Banks fulfill. Hence, I believe it is in all our best interests to gauge today how best any reform effort will enhance and not diminish the secondary mortgage market.

The purpose of today's hearing is to engage, I hope, in a constructive dialogue about matters of great importance. The subject we take up today relates solely to the housing GSEs, Fannie Mae, Freddie Mac, and the Federal Home Loan Banks, and not to any other industry and not to any other entity that may have ties to the federal government.

The legislation at hand is designed to consolidate, strengthen, and increase regulatory oversight of the three housing GSEs in order to enhance transparency and market discipline with regard to the housing GSEs and thus avoid and reduce problems related to both systemic and taxpayer risk.

It has been suggested of late that the best litmus test for any reform initiative is to make sure that the end result of the initiative is good for home owners. I agree completely, and would add that the initiative

should also be seen as providing some significant good for American taxpayers. And since every single homeowner, to my knowledge, is also a taxpayer, these two ends are not, and should not be perceived to be, mutually exclusive.

My interest in these issues dates back at least five years, to the time I first became Chairman of the Capital Markets Subcommittee. In that time I have conducted numerous hearings and been involved in numerous consultations with the General Accounting Office, the Congressional Research Service, and the Congressional Budget Office. And it is primarily their studies and proposals for more efficient oversight that form the backbone of the legislation we discuss today.

In our first hearing, the Subcommittee heard extremely constructive testimony from the regulatory agencies OFHEO and FHFB. The Subcommittee also received generally positive testimony from the Treasury Department and the Department of Housing and Urban Development. Indeed, the Administration's ringing approval of many of the bill's proposals give us sound reason to pursue subsequent rounds of inquiry that we may weigh every possible perspective on these matters.

According to the Administration, the explosive level of growth of the housing GSEs, and the amount of growth in their combined debt holdings, poses significant concern for systemic risk, risk that deserves the fullest attention and response if Congress is to avoid passing along that risk to taxpayers.

Federal Reserve Board Chairman Alan Greenspan doubtless is on the minds of many today, and although he has not commented directly on the issues here, I believe it is constructive to consider some of his remarks at a May 4 meeting of the Chicago bank, when he stated:

"We must be careful not to foster an expectation that policymakers will ultimately solve all serious potential problems and disruptions. Such a conviction could lull financial institutions into believing that all severe episodes will be handled by their central bank and hence that their own risk-management systems need not be relied upon. Thus, over-reliance on public policy could lead to destabilizing behavior by market participants that would not otherwise be observed-what economists call moral hazard.

"There are many that hold the misperception that some American financial institutions are too big to fail. I can certainly envision that in times of crisis the financial implosion of a large intermediary could exacerbate the situation. Accordingly, the monetary and supervisory authorities would doubtless endeavor to manage an orderly liquidation of the failed entity, including the unwinding of its positions. But shareholders would not be protected, and I would anticipate appropriate discounts or 'haircuts' for other than federally guaranteed liabilities."

Our task today is to discover the views of the housing GSEs themselves, and to receive from the witnesses who represent them insight on a number of unanswered questions:

First, do the witnesses agree with the Administration that their securities are not backed, explicitly and implicitly, by the full faith and credit of the United States Government? Do the witnesses agree with the Administration that their various lines of credit with the Treasury should be repealed? If, as it has been maintained by many, these lines of credit are merely symbolic in nature, what reservations do these witnesses have in their possible repeal?

Second, and more broadly, do the witnesses desire to see the oversight of their institutions strengthened, and do they agree with the General Accounting Office that there exists a need for stronger, more efficient, and independent oversight of their activities? Likewise, do the witnesses agree that greater scrutiny needs to be given to their expansion into new activities, particularly those outside the scope of their missions?

Finally, I hope we may discuss questions related to a variety of specific topics, including the practice of and possible greater risk involved in the GSEs buying back their own MBSs; the relationship between

fluctuations in mortgage rates and the profits earned by the GSEs; and the relationship between the government subsidy received by the GSEs and the relative benefits it imparts to potential home buyers.

I think I speak for every member of the Subcommittee in expressing my interest in strengthening the secondary mortgage market. Consequently, I am hopeful that today's hearing may be an opportunity for us to begin a constructive process of working together, building consensus, and demonstrating mutual respect in each other's efforts to make that possible.

To that end, I would like to emphasize that we should all consider not only what is good for the secondary mortgage market today, but also what is good for the secondary mortgage market tomorrow, the next day, and ten years hence. Let us remember and agree that the American dream of home ownership must be preserved not only for our generation but for future generations of Americans.

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1) What gives Fannie confidence that the asset-liability mismatch of the early 1980s could not happen again?

2) What gives Fannie confidence that, should economic stress occur, its interest-rate risk counterparties (swaps and interest-rate caps and floors) will be able to perform?

3) How much would it cost the average American homeowner if the mortgage and swap market would ever falter in the unlikely event that Fannie Mae ever experienced serious balance sheet problems? The purpose of this committee and of Congress in general is to protect the best interests of the American taxpayer. Would Fannie not agree that the cost of crisis prevention or of not regulating the GSEs would far outweigh the alleged costs of simply asking reasonable and prudent questions about the safety and soundness of Fannie's operations?

4) Does Fannie have or can it provide an estimate how much the spreads would widen if in the unlikely event of balance sheet stress, Fannie Mae had to liquidate inventory?

5) If, as Fannie has discussed with many investors, the implicit guarantee is only "symbolic" what type of government involvement would Fannie anticipate if FNMA were to experience financial difficulties?

6) If the implicit guarantee is only "symbolic" what rating would FNMA expect to have without this perception of the government standing as the lender of last resort? Explain the basis for this opinion.

7) Fannie Mae has argued that the line of credit is purely symbolic, if so, what does it symbolize and what role does it play in your operations and in your marketing?

8) Should any investor or stockholder rely on the Government to protect you in case of financial difficulty or default?

9) In the case of LTCM, no taxpayer money was actually spent in its rescue, but instead the private sector bankers to LTCM were asked to put up additional capital. This concept of "bailing in" investors or creditors to an institution has become a key policy objective of the US Treasury, the International Monetary Fund, and indeed the international financial regulatory authorities. Does Fannie think that such a "bail-in" of creditors and investors, if it should ever be applied to Fannie Mae in the unlikely event of it experiencing serious balance sheet problems, is adequately recognized by its investors and reflected in its yield?

10) What role did Fannie Mae play in helping Orange County, California and Long Term Capital Management out of their financial difficulties? Did you issue debt securities to assist in the process of salvaging the county or the company?

11) What is Fannie's position in reply to the extensive points made by chairman Greenspan in his recent speech in Chicago and does Fannie think the chairman was referring to a situation similar to that of the GSE's when he warned that: *"There are many that hold the misperception that some American financial institutions are too big to fail. I can certainly envision that in times of crisis the financial implosion of a large intermediary could exacerbate the situation. Accordingly, the monetary and supervisory authorities would doubtless endeavor to manage an orderly liquidation of the failed entity, including the unwinding of its positions. But snareholders would not be protected, and I would anticipate appropriate discounts or "haircuts" for other than federally guaranteed liabilities..." Would Fannie expect its investors to take "haircuts" in the event of a dramatic corporate or economic crisis?*

12) Both Fannie Mae and Freddie Mac are on record as saying that the stress test must adequately capture the risks that you actually face. In what ways is the statutory stress test too rigid to allow the regulator an ability to capture those risks?

13) What series of tests would Fannie recommend constitute the core of a risk-based-capital stress test? What types of economic conditions? What correlations of interest rate and credit risk? Explain your recommendations?

14) Fannie Mae has stated on several occasions that a bank or thrift institution would require much more capital if it were to meet the risk-based capital requirement now being developed by OFHEO. Provide documentation of this assertion, including clear statement of all assumptions, and submit to the Subcommittee the complete specifications of any models that support the assertion.

15) It is our understanding that First Manhattan, New York, New York, prepared the analysis for Fannie Mae that allowed Fannie Mae to assert that the capitalization requirements for Fannie were at least as stringent, if not more so, than a bank or thrift. Please submit First Manhattan's complete analysis for the record.

16) Treasury Undersecretary Gary Gensler testified that at mid-year 1999, banks held \$210 billion in GSE securities – just under 4% of total bank assets and over one-third of total bank capital – constituting a "significant portion" of the assets of the US banking system. Currently, Fannie and Freddie debt does not come under the same restrictions as other debt. Current law limits the bank's amount of credit exposure to any one entity. While national banks cannot hold more than 10% of their capital in the corporate bonds of any one issuer or lend unsecured more than 15% of their capital to any one borrower, there are no limits on the holdings of GSE debt. There seems to be an over-concentration of risk in the US banking system if one-third of bank capital can be held in GSE securities. Do you oppose efforts to limit the banks' holding of GSE debt? If you do oppose limitations on the amount of GSE debt, then why not eliminate the restriction that national banks cannot hold more than 10% of their capital in the corporate bonds of any one issuer?

17) Officials at Fannie Mae have asserted that higher capital requirements will prevent them from fulfilling their affordable housing commitment. HUD studies show that financial institutions with higher capital requirements than Fannie Mae are doing a better job at meeting affordable housing needs than Fannie Mae is – and these institutions have higher capital requirements. Why does Fannie Mae tie affordable housing goals to capital?

18) What impact would there be to FNMA's borrowing costs if bank holding requirements were limited to 30% of their total capital, as opposed to current unlimited exposure?

19) H.R. 3703 offers a defined new-program-review process which sets deadlines for regulatory action. We are sensitive to Fannie's concern that such reviews do not hamper your abilities to innovate and test new products on a trial basis. HR 3703 provides a materiality criteria in order to protect you in this area. Now you must also understand Congress' concern that we guard against any profit motives for you to breach the limitations of your charters by expanding into new markets. What are your ideas for balancing these two competing interests?

20) Given that the Fannie Mae charter act states that the corporation may deal only in mortgages that are of institutional quality, how do you justify your entry into subprime markets?

21) Most so-called subprime mortgages are used to serve moderate-to-higher income people who use their homes to consolidate outstanding obligations. Is Fannie Mae willing to commit to purchase only those subprime loans that are purchase money mortgages for first-time, low-to-moderate income homebuyers who intend to live in the homes they are purchasing?

22) Are you trying to position your debt securities to become replacements for Treasury benchmarks in the years ahead?

23) Why does Fannie oppose taking OFHEO out of the appropriations process?

24) It has been reported that Mr. Raines recently commented at an investor analyst's meeting in New York City where he assured the analysts that Fannie Mae had plenty of room to grow in terms of percentage of revenues in the mortgage industry and that this growth is not limited to loan purchases, but all aspects of mortgage creation and servicing. Would you please comment on this?

25) Do you not agree that efficiencies could be gained by combining the regulation of GSEs engaged in managing the same risks? (Interest-rate risk on debt issuances which support home mortgages; credit risk on the home mortgages themselves.)

26) Bloomberg reports on your briefing in London last week at which Fannie said it was optimistic about meeting its goal of doubling Fannie Mae's earnings-per-share by 2003. Fannie Mae already earns ROEs of at least 25 percent each year. Would you object to sharing some of this government-sponsored profit by contributing 10 percent of net income each year to an Affordable Housing Fund?

27) What would be the impact to consumers, on a monthly after-tax basis, if Congress passed a law to cap the size of Fannie Mae's and Freddie Mac's portfolios at several hundred billion dollars, and required the two GSEs to securitize the remainder of their mortgage purchases? In responding the question, We would prefer that the consumer impact be broken out by mortgage size, beginning at $50,000, in $25,000 increments. Please provide the underlying assumptions for your calculations. If this cannot be answered at this moment, please submit the appropriate data for the record.

28) You have spoken about the many contributions that Fannie Mae and Freddie Mac have made to the American system of housing finance. Would you object to legislation to permit the creation of new GSEs that would operate under charters that are virtually identical to those of Fannie Mae and Freddie Mac?

29) Fannie Mae has a home improvement pilot partnership with Home Deport in which it purchases loans offered at Home Depot stores. As we understand it, at least some of the loans will not be secured by a residential property. Chevy Chase Bank is the lender in the Home Depot/Fannie Mae pilot and borrowers are allowed to purchase home improvement products on a list approved by Fannie Mae. How does financing hot tubs and marble countertops fit with your mission of providing liquidity to the secondary mortgage market or promoting homeownership? Wouldn't these homeowners be able to get financing for these products without a GSE subsidy? This not what Congress intended the GSEs to subsidize. Please explain how participating in this program puts those most in need in a house?

30) While the Fed has been trying to reign in the booming economy, concerns have been mounting that the GSEs' rapid growth may be creating a "economic credit bubble," which artificially raises home prices and creates economic distortions in the market. Are the GSEs fueling a "mortgage or economic bubble?"

31) Describe all agreements by Fannie Mae to manage and/or dispose of real estate for third parties, such as the U.S. Marshals Service. How much real estate has Fannie Mae managed or disposed of in the past five years for third parties?

32) Fannie Mae does not pass all of its savings it receives from paying no taxes and implying it has a federal guarantee along to homeowners. Instead it uses almost a third of that subsidy to finance the compensation of its senior executives and to pay its shareholders such a high rate of return, which in turn is also driving the value of the options granted to the senior executives. In addition, it is able to set

such a high ROE and compensation level because Fannie has no competition in the market that could force them to pass on more to the homeowner. We are concerned with this fact and would like to know how much the average homeowner would save if the entire subsidy Fannie receives was to be passed along to the homeowner?

33) HUD Assistant Secretary Apgar recently stated that the consequence of Fannie Mae's automated underwriting system was to potentially result in the disqualification of low income applicants. His words were that "the system was potentially discriminatory." Fannie took great offense to that allegation. Can Fannie provide this Committee information that disputes this claim? And further, can Fannie explain why its percentage of minority loans is well below that of the average for commercial banks nationwide?

34) In determining the total costs of a loan to an individual with a poor credit score, does Fannie Mae attach a premium, that is, a higher interest rate to that borrower, contrasted with a fully credit qualified borrower? If you do, shouldn't it be the other way around for a GSE? Shouldn't the wealthier borrower help to subsidize the low income applicant?

35) Does Fannie Mae receive different prices for mortgage guarantees for the same loan amount with the same credit risk depending on the potential market share represented by the loan originator? We have on good authority that Fannie offers lower guarantee pricing to large originators such as Countrywide and then charges smaller or less established originators higher guarantee fees to compensate for the differential. Is this true? If so, how does that practice promote lower homeownership costs and achieve consistent mortgage pricing throughout the market?

36) Why did FNMA create the Fannie Mae Foundation? What can the Foundation do with regard to issues before Congress? What is the total income to the Foundation and where does it come from? Who decides how or where the Foundation spends its money? Where has the Foundation sponsored projects over the last ten years? Has the Foundation ever been audited? Are there other "outreach" programs that complement Fannie Mae?

37) Since Fannie Mae is a corporation subject to Congressional oversight, we can understand some allocation of resources to maintain a balance in potential political risk. Given Fannie Mae officials historically have stated that management of political risk is as significant as management of other business risks, how many employees are assigned a government relations responsibility and what is the total expenditure annually for them? How many outside firms or organizations do you currently have under contract and what is the total expenditure annually for each representation? Is this activity intended to help low income, first time homebuyers have access to homeownership?

38) How is it that Fannie Mae's repurchase of its own mortgage backed securities expands homeownership opportunities? It sounds more like an arbitrage play. Isn't it a fundamental rule of economics that if there are more buyers in the marketplace, the price of a product is increased? Don't Fannie Mae's purchases of its own MBS simply prop up the price of these securities? Doesn't the retention of MBS in portfolio increase interest rate and credit risk to enrich shareholder wealth? What, if any, are the benefits to homebuyers?

39) Why is Fannie Mae's return on equity so much higher than its private sector secondary mortgage competitors? Give reasons other than its lower cost of funds.

40) If these lower costs of funds (interest rates) lead to a higher return on equity – a rate which is lower because of Fannie and Freddie ties to the government - doesn't this amount to an indirect federal subsidy to Fannie Mae's stockholders, and why should the federal taxpayer subsidize Fannie stockholders' income?

41) What is it in Fannie Mae's performance – not in its chartered mission – that justifies its exemption from state and local taxes and from SEC registration fees?

42) How would a refinancing boom caused by a severe drop in interest rates affect Fannie?

43) Why does Fannie issue so much short-term debt?

44) How much of Fannie's long term assets are funded by short term debt and how would severe losses in Fannie's portfolio effect Fannie's ability to borrow funds?

45) If Fannie was forced by market conditions to sell its portfolio quickly, how would that affect the secondary market for mortgage-backed securities?

46) Fannie is one of the biggest users of the derivatives markets. Does this imply that there may be some other risks that are not properly capitalized?

47) Please describe how Fannie Mae is using Community Development Financial Institutions (CDFIs) to meet its affordable housing goals.

48) Now that Fannie Mae is purchasing more loans of lower credit quality (subprime), how will it manage the higher credit risk?

49) As a challenge to those who say that outstanding Fannie Mae/Freddie Mac debt will shortly exceed outstanding Treasury debt, Fannie Mae has referred to "debt to the penny" estimates that include the Social Security Trust Fund in outstanding Treasury debt. These are not the debt numbers cited by the Clinton Administration and the Treasury when they estimate that debt to the public can be fully repaid by 2013. Why does Fannie Mae use different numbers?

50) Fannie Mae has a very visible advertising campaign on national television and radio as well as in local and national print media. How does advertising to the general consumer help lower homeownership costs? What business purpose is Fannie trying to achieve?

Rep. Stephanie Tubbs Jones

Good Morning. Chairman Baker, Ranking Member Kanjorski and Members of this Committee. Mr. Chairman, I ask unanimous consent that my full statement be included in the Record.

Mr. Chairman, we are here this morning to discuss H.R. 3703, the Housing Finance Regulatory Improvement Act. This bill is designed to improve regulation and supervision of the housing GSEs. It is my hope this morning that we will be able to discuss the issues surrounding this legislation and the challenges it presents, not singularly to GSEs, but to the ability of future homebuyers to secure homes and for others to obtain affordable housing.

Housing, Mr. Chairman, as we well know, is a key public policy concern. It was a concern in 1968 when the GSEs were formed and it is a concern even in the year 2000. In cities and suburbs nationwide, there is an affordable housing crisis. There are citizens, in this nation, including the 11th Congressional District, where individuals and families are struggling with skyrocketing rents as well as inadequate housing stock.

GSEs were established to address these problems. In 1992, Congress passed Federal Housing Enterprises Financial Safety and Soundness Act (FHEFSSA) that mandated Fannie Mae and Freddie Mac to ***"lead the mortgage finance industry in making credit available for low- and moderate-income families."*** From my understanding of GSEs, they are fulfilling this mission Thus, I am glad today that we have representatives from the GSEs to make their own case to include Chairmans Leland Brendsel, Freddie Mac, Curtis Hage, Council of Federal Home Loan Banks and Franklin Raines, Fannie Mae. I applaud you and the Ranking Member's efforts to provide this committee with a balanced view of the issues surrounding this legislation.

Let me be clear. To clarify the National Journal's statement relative to my legislative position, I want to be clear that I support affordable housing and increased homeownership, be it Fannie Mae, Freddie Mac, mortgage lenders, etc. I am committed to affordable housing and increased homeownership to spread economic prosperity around in this nation.

Mr. Chairman, I proudly represent the 11th Congressional District of Ohio. It is a richly diverse district of nationalities, religions and economics. It includes the wealthiest citizens to those with little or no means. It includes the well-educated to those who struggle to secure a decent education. However, there is one key commonality with both ends of this population continuum—housing.

I realize Mr. Chairman that putting a family into a home is much more than originating a mortgage, automated underwriting systems or implicit/explicit relationships. Putting a family into a home provides a family with, in many instances, its first real asset or even provides a legacy for future generations. Homeownership, I believe, is one of the

key first steps to true empowerment. Thus, we cannot take this process nor this legislation lightly.

With the provisions granted GSEs, I believe in the importance of safety and soundness. I believe that the GSEs have met this challenge. Both Fannie Mae and Freddie Mac have both received passing grades on each and every OFHEO (Office of Federal Housing Enterprise Oversight) capital adequacy test. Thus, if the question is adherence to mission and charter, then let us discuss that and move on to the business of providing new hope via housing for citizens.

As our nation transformed itself from its industrial base to an information and technological power, we, as members of this Committee, have championed public/private partnerships as well as market innovation, yet I sense we have taken a different approach with respect to the GSEs. I do not wish to legislate where no legislation is warranted. Moreover, I do not support efforts to increase the regulatory burden placed on GSEs, burdens that will ultimately be passed on to consumers. If the information suggests GSEs have not done what they are required to do, let's fix it and move on. If the GSEs, however, are on track and are accomplishing their mission, again, let us move on. We all should remember the market impact stemming from Mr. Gensler's testimony. It is my hope that this committee continues to support the mission of the GSEs and support affordable housing and homeownership.

Mr. Chairman, I am challenged by some aspects of your bill. I am concerned about:

- Increased regulatory burden of the legislation. Simply mixing and matching regulators will not accomplish desired goals.
- A five-person politically appointed board does not seem to me as a model for a safety and soundness regulatory structure.
- Creating great delays in bringing new products to the market and hinders, subsequently, new and innovative products to consumers.

Mr. Chairman Fannie Mae, in particular, in my district, provided $371 million in mortgage financing to 5,484 families. There is no way product creativity and innovation can occur with any GSE when there is a 90-day waiting period, much like a new government program or regulation. With the growth and speed of the internet and e-commerce in our new e-mocracy, companies cannot be successful under those constraints, thus, consumers are hurt.

I hope this hearing serves to clear the record. I realize that there is much more to be done by GSEs with respect to affordable housing. While homeownership rate sit at or around 67%, there is still room for minorities and homeownership opportunities.

Mr. Chairman, in the midst of positive news about housing, I do not see bringing forth additional regulations where there is no decrease in safety nor soundness, which I

thought should be the basis for any improvements. Let us improve upon what is already in place.

Mr. Chairman. Cleveland and Cuyahoga County are undergoing an affordable housing crisis. In order to address this crisis. I have challenged Fannie Mae, in my district, to address and improve upon their efforts in dealing with this concern. Until someone can demonstrate to me a tangible "quality of life improvement" for families living on the East side of Cleveland, I will remain opposed to this bill.

Mr. Chairman, there has been some good to come out of these hearings, I must say. Since our initial hearing on H.R. 3703, the work and effort, or lack thereof, of many banks, mortgage lenders, GSEs, etc, have become more transparent and that's good for all consumers. Thank you again Mr. Chairman and I look forward to the hearing.

Paul E. Kanjorski

1OPENING STATEMENT OF RANKING MEMBER PAUL E. KANJORSKI
SUBCOMMITTE ON CAPITAL MARKETS, SECURTIES,
AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON H.R. 3703,
THE HOUSING FINANCE REGULARTORY IMPROVEMENT ACT

TUESDAY, MAY 15, 2000

Mr. Chairman, thank you for the opportunity to speak briefly before we begin our second hearing on H.R. 3703, the Housing Finance Regulatory Improvement Act.

At our last hearing in March on this legislation, we heard from the present regulators for the housing government-sponsored enterprises, or GSEs, as well as the U.S. Department of the Treasury. During my opening remarks at that hearing, I noted that we should move forward cautiously in considering this bill so as to ensure that we maintain the delicate balance that has led to 67 percent of U.S. families owning their homes.

Another issue that I raised during my March statement concerned the possible effects of H.R. 3703 on investors. Some have suggested that our last hearing may have inappropriately discouraged investors and raised homeownership costs. As noted in the *Wall Street Journal* and other news outlets, our capital markets experienced disruptions in which the cost of funds for Fannie Mae, Freddie Mac, and the Federal Home Loan Banks increased in the days following our initial hearing. According to these accounts, the spread — or the difference in yields between GSE debt and 10-year Treasuries — increased by as much as 14 basis points. Spreads on mortgage-backed securities guaranteed by Fannie Mae and Freddie Mac also widened.

As we proceed today, we must renew our efforts to ensure that we do not accidentally raise homeownership costs. Moreover, Mr. Chairman, as I indicated in my letter of March 31 to you, we should not move precipitously and attempt to legislate in the 106th Congress on this complex and important set of policy issues. We should, however, continue to use H.R. 3703 as a focus for our oversight activities.

In the weeks following our last hearing, I have also had the opportunity to meet with many of the parties affected by this legislation, including those who support, those who oppose, and those who remain neutral on the bill. During these discussions, I have heard many reasons for and against moving ahead. Many of the arguments for and against the bill appear credible when made on their own merits and without someone testing their basis

In my opening remarks at our last hearing, I suggested that we should convene a roundtable discussion with the interested parties to better understand the need for and implications of this legislation on our housing finance system. I still believe that a roundtable discussion is the most appropriate forum for our consideration of these issues.

A roundtable discussion would force the participants to challenge each other's assumptions and assertions in an open environment. It would also provide us with greater insights than testimony that has been vetted and sterilized through the clearance process. A roundtable debate would further allow us to more fully educate Members about the substantive issues involved in this debate and the real effects that this legislation would have on the housing finance marketplace.

In closing, Mr. Chairman, I hope that as we continue to consider these important issues you will join me in working to lower homeownership costs. I also hope that for our next hearing you will invite the parties interested in this bill to participate in a roundtable debate so that we can have a free, fair, and vigorous deliberation on the future role of the GSEs in our housing finance system.

Opening Statement of Frank Mascara

Thank you Chairman Baker and Mr. Kanjorski for focusing our attention, today on a very important role of this Committee, the role of the federal government in promoting home ownership.

I would be remiss if I didn't commend the GSEs for their role in providing opportunity to homebuyers in my community. Their value to Southwestern Pennsylvania cannot be understated.

I greatly appreciate that all three chairmen took time out of their busy schedules to appear before us today.

This is a very timely issue receiving considerable media attention. And for a very good reason. Homeownership has never been available to so many people as it is now. Mortgages have never been as affordable as they are now.

Our nation's housing finance market is a model for the international community. There is significant competition, providing consumers a wide range of services at competitive rates.

The concerns I have today relate to the rhetoric that has escalated on both sides of the GSE issue. I hope that our panelists today can shed some light on these matters with some direct and thorough testimony.

Much has been made about debt escalating out of control. There are dire predictions that the GSE debt will soon exceed the U.S. Treasury debt, and Assistant Secretary Gary Gensler of the Treasury recently compared the GSE debt to that of the thrifts preceding the savings and loan crisis. I hope that our panelists would address the nature of GSE debt relative to Treasury's and that of the savings and loans.

The other concern I have is regarding the automation of loan purchases in the secondary market. Chairmen Raines and Brendsel, your companies have developed programs that can approve loan purchases in the secondary market *during* the process of loan origination.

Chairman Brendsel, Freddie Mac has recently partnered with Microsoft to provide online loan services which could even further speed this process. It would appear that these technological developments blur the distinction between loan origination and the secondary mortgage market.

Hopefully, the panelists will explain to this Committee how these activities remain within their mission, and do not pose a threat to the market for loan origination.

Congresswoman
Marge Roukema

Fifth District — New Jersey

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Release:
May 16, 2000

Roukema Statement on GSE's

U.S. Congresswoman Marge Roukema, R-N.J.-5th, today issued the following statement at a hearing on regulation of housing-related Government Sponsored Entities, held by the House Banking Committee's Subcommittee on Capital Markets.

"I would like to make my position perfectly clear. This legislation is highly complex. We should not move legislation until we have examined it thoroughly and understand the possible consequences on the American Dream. It is absolutely essential that we identify and quantify the potential positive and negative consequences from any legislative or regulatory changes. This must be done before Congress takes any action. I think most Members want more Americans to own more homes, not less. Clearly, we must be alert to the potential liabilities of the GSE to the taxpayers and alert to their capital standards. In other words, we don't want to be setting us up for a taxpayer bailout."

"Finally, I am specifically concerned about GSE mission creep. GSEs are not supposed to, as a general rule, compete with the private sector except where explicitly authorized by Congress. I know that there are real concerns about Fannie and Freddie expanding their lines of business. For instance, some suggest that they are getting into real estate brokerage, consumer lending, mortgage insurance and other areas which are arguably not part of their mission. These are serious charges which I strongly believe Congress should examine."

— 30 —

Congressman John E. Sweeney
Committee on Banking and Financial Services
Hearing on H.R. 3703, Housing Finance Regulatory Improvement Act of 2000
May 16, 1999

Thank you , Mr. Chairman for holding this hearing on the Housing Finance Regulatory Improvement Act of 2000.

I think it is also imperative for us to determine if the GSE system actually requires additional regulation. Does a problem truly exist?
Or, are GSE structures and regulatory procedures currently correct?

My office has recently received an overwhelming amount of form consistent mail on this topic. This gives me the suspension that additional attention should be given to these proposed changes. I am sure this hearing will help answer some of those questions.

Conversations regarding oversight of GSEs are important because our actions protect the public's interest in these affairs. We must ensure that the GSEs are not operating outside of their established charter. Our charter is to keep tabs on the risk GSEs assume, as increased risk could equate to significant losses should our economy cool down.

Conversely, our nation's housing finance system is the envy of the world and has stimulated home ownership to great heights - 67% of Americans now own a home. GSEs significantly contribute to that success through their investments in the secondary market.

I am also concerned about Wall Street's reaction to our most recent hearings on this subject. Following that hearing, the spread between long term interest rates and bonds expanded rapidly. That reaction certainly warrants close examination. What is the investment communities' perception about this legislation? Did that perception influence the rate movements?

I look forward to hearing the opinions of the witnesses called before the subcommittee today. I am interested in hearing their view on what the impact of this legislation will be on the citizens of my Upstate New York Congressional District.

Thank you, again, Mr. Baker, for holding this important hearing.

Statement of Representative Maxine Waters
House Banking and Financial Services Committee
HR 3703, the Housing Finance Regulatory Improvement Act of 2000
May 16, 2000

Fannie and Freddie Pass Their Benefits to American Consumers in the Form of Lower Mortgage Rates

Fannie Mae and Freddie Mac are government-sponsored enterprises (GSEs) that are congressionally chartered, but shareholder-owned corporations. They enjoy federally-granted benefits in support of their important public purpose which is to increase nationwide access to residential mortgages by developing and supporting a secondary mortgage market for housing finance. Fannie and Freddie pass their federally-granted value on to mortgage borrowers in the form of lower interest rates.

According to a June 2000 article in Money magazine, America's soaring homeownership rates and the reduction in downpayment requirements are evidence of Fannie and Freddie's benefits to American consumers. Similarly, a 1996 Congressional Research Service report stated that "Comparisons of mortgage rates in conforming and non-conforming markets have led analysts to conclude that the presence of the GSEs has lowered mortgage rates between 25 and 50 basis points." Lower mortgage-rates result in thousands of dollars saved for American consumers. In addition to making homeownership affordable for American consumers, Fannie Mae and Freddie Mac's organizational efficiency is also noteworthy.

A Strong-Capital Base, Efficient Management, and Diversity make Fannie Mae and Freddie Mac two of the strongest companies in the country

Fannie Mae and Freddie Mac are two of the strongest companies in the country. Fannie Mae ranks 26th and Freddie Mac 62nd on the Fortune 500 list of top American companies. Currently, Fannie Mae holds more than $19 billion in capital. In its 1999 report to Congress, the Office of Federal Housing Enterprise Oversight (OFHEO)–the congressionally-appointed safety and soundness regulator for Fannie Mae and Freddie Mac–found both "Enterprises to be financially sound and well managed." OFHEO also stated that "Fannie Mae exceeds safety and soundness standards in all categories."

In 1997, at the request of OFHEO, the rating agency Standard and Poors evaluated Fannie Mae and assigned them a AA- rating in terms of their risk to the government- a rating only a handful of institutions meet. Additionally, in July 1999, Fortune magazine named Fannie Mae the second best company for employment in the country for Asian-Americans, African-Americans, and Hispanic Americans.

HR 3703 and FM Watch will lower mortgage rates for consumers so banks can make a bigger profit

Despite the benefits they provide to American consumers and the efficiency of their organizations, there are entities that seek to undermine the ability of Fannie and Freddie to lower mortgage rates. A June 13, 2000 article in the National Journal, stated that Baker's legislation (legislation that creates unnecessary regulatory burdens and stifles innovation for the GSEs) "is likely to get a boost from FM Watch, the cadre of disgruntled lending companies that fears Freddie and Fannie's quest for additional business and profits will create new subsidized competitors."

Money magazine was more specific. Referring to FM Watch, Money magazine stated "What most concerns the coalition is Fannie and Freddie's desire to move into the lucrative area of subprime lending. That would do borrowers who don't have perfect credit a world of good." Chuck Gabriel, a Prudential Securities analyst stated the issue succinctly when he said, "Every new product Fannie and Freddie announce seems to bring direct benefits to consumers. The only problem? More business for the GSEs could hit big lenders in the pocketbook."

If FM Watch Wins, Consumers Lose

Homeownership is without question the single most important means of accumulating assets. If HR 3703 is passed and FM Watch gets their way, mortgage rates will rise and American consumers will lose.

Embargoed Until May 16, 2000, 10:00 a.m.

Statement of Franklin D. Raines

Chairman and CEO, Fannie Mae

Before the House Subcommittee on Capital Markets, Securities,

and Government Sponsored Enterprises

May 16, 2000

Thank you, Chairman Baker. I appreciate the opportunity to speak to the Subcommittee today about Fannie Mae, our regulatory structure, our role in the marketplace, and the concerns you have raised.

I also want to take this opportunity to recognize the importance of this Subcommittee's oversight of the housing finance system. The housing finance system is crucial to the American people who overwhelmingly aspire to be homeowners. I appreciate the work that you and your colleagues on the Subcommittee have done to strengthen homeownership in America, and I look forward to an ongoing dialogue.

The United States Housing Finance System

From the perspective of both consumers and investors, the U.S. housing finance system is the best in the world. While most of the G-7 countries have a well-developed mortgage finance industry, the mortgages they offer are less consumer-friendly. In the U.S., for example, we take the 30-year, fixed-rate mortgage for granted, with downpayments as low as five and three percent. That is not the case in Germany, France, the United Kingdom, or Japan. In Germany, the down payment is typically 35 to 40 percent, and in Japan, homebuyers have to put 50 to 60 percent down.

And unlike in the United States, the long-term fixed-rate mortgage is a rarity in these countries. Last year, 66 percent of all conforming mortgages originated in the United States were 30-year fixed-rate mortgages. In Canada, rollover mortgages have a fixed rate during the first one to five years, with a prepayment penalty equal to 3 months of interest; at rollover, borrowers select another mortgage period. The fixed-rate term in Spain and France is about 15 years, and 5-10 years in Germany. And homeowners cannot refinance during this period unless they pay a huge penalty.

Why are low down payment, fixed-rate mortgages with an option to refinance at little or no cost so common here and a rarity elsewhere? The difference is Congress's long-standing commitment to homeownership and Congress's decision to create what has become a well-developed, sophisticated secondary mortgage market that meets the needs of both homebuyers and investors.

It is worth spending a few minutes on how the secondary market works. [CHART 1] Lenders originate mortgage loans in the primary market. (Fannie Mae does not originate loans. Our charter does not allow it and we are not equipped to handle direct contact with consumers.) Lenders can either sell the mortgages they originate to investors in the secondary market or retain them in their own portfolios. When lenders sell their mortgages, they replenish their funds so they can lend more money to homebuyers.

Fannie Mae's role is to transform mortgage risk into the various forms that investors want to buy. [CHART 2] For example, some investors want the higher returns they can get from investing in mortgage-backed securities (MBS). MBS are created when a lender comes to us with a pool of mortgages and pays us a fee to guarantee the creditworthiness of those loans. The lender then sells the mortgage-backed security to Wall Street and other investors. Some investors choose to buy MBS because they want the yield that comes from taking the prepayment risk — the risk that borrowers will repay their mortgages (if interest rates fall) and thus reduce the cash flow from the MBS investment — but want the liquidity and lack of credit risk in MBS. (Indeed, if investors want to take both interest rate and credit risk and sacrifice liquidity, they can buy whole mortgage loans from lenders without the Fannie Mae credit guarantee.)

Fannie Mae performs a similar role with regard to credit risk, working with our risk-sharing partners such as lenders, mortgage insurers and others to transform the risk of default on each loan into exposures each partner is best suited to hold.

There are a few important points I want to emphasize about the MBS market. First, Fannie Mae does not ordinarily sell MBS to Wall Street; lenders do. Once Fannie Mae has securitized a pool of mortgages into an MBS, the lender owns that MBS and can either hold it or sell it to investors, one of whom may be Fannie Mae.

Second, the price of MBS is set by a highly liquid and efficient market. The most recent data available indicate that dealers traded $70.6 billion worth of MBS during the week of May 3, 2000, and April 2000 MBS settlements were approximately $330 billion. Fannie Mae does not set prices in that market. The fee that we receive from securitizing mortgages is related only to the credit risk (and the remittance schedule) on those loans. Indeed, when the demand for MBS rises and prices go up, Fannie Mae's credit fees remain the same.

The benefit that Fannie Mae MBS receive from our charter flow directly from Wall Street to lenders and then to consumers. Fannie Mae is also an investor in the MBS market, however, and as such, we compete with other investors on equal footing. Like any other large investor, we can influence the market to the extent that the addition of our demand in the market raises prices and, in turn, lowers mortgage rates. That is precisely the role we played in the 1998 credit crunch. When other investors withdrew from the market, we stepped up our purchases, which kept mortgage rates low.

Third, the market price is set by the actions of many buyers and sellers. Because we help supply the market with securities in demand by investors, we increase the flow of funds into the mortgage market and thereby drive down mortgage rates for consumers.

But some investors do not want to take the prepayment risk that comes with MBS. Instead, they may want to purchase an investment that has a more predictable cash flow — at the cost, of course, of a lower yield. Fannie Mae's role is to make it possible for these investors to participate in the mortgage market. We do this by purchasing mortgages and MBS and selling debt securities to pay for those purchases. Our various debt securities give investors two basic choices. Investors can buy some — but not full — prepayment risk by purchasing our callable debt securities. Callable debt is debt that Fannie Mae can redeem earlier than its stated maturity if interest rates fall and homeowners refinance their mortgages faster than expected. Or investors who want the liquidity and predictability of a traditional debt instrument can buy our bullet — or non-callable — debt securities. These debt securities provide the greatest predictability; Fannie Mae must repay at, and only at, the stated maturity date.

MBS, callable debt, and bullet debt are the three primary ways that Fannie Mae transforms the risk of fixed-rate, long-term mortgages — which have illiquid, unrated, unpredictable cash flows — into securities that are liquid, high-quality, and have cash flows covering a range of predictabilities. The reason that the U.S. mortgage market is so efficient is that investors can find almost any combination and level of prepayment risk and yield in one of these three securities. And within these three categories, we create highly specialized security structures for large investors who have very specific risk demands. By creating securities that are attractive to the broadest universe of investors, Fannie Mae and Freddie Mac increase the demand for mortgages, which raises the prices of MBS and, in turn, lowers mortgage rates for homebuyers.

The Legislative Framework For Fannie Mae

The best starting place for a discussion of Fannie Mae's role in the market is the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the "1992 Act").[1] This law made significant changes to Fannie Mae's charter and our regulatory structure, providing the foundation for the successful secondary market that exists today.

In the early 1990s, Congress took up legislation to change Fannie Mae's and Freddie Mac's overall structure for mission and financial soundness. Congress considered the issues against the backdrop of the failures in the thrift and banking industries during the 1980s and early 1990s — the resolution of which cost the American taxpayer about $125 billion and took close to a decade to resolve. The Banking Committee was deeply involved in the policy decisions needed to correct the poor regulation, reckless investments, and inadequate capital that caused many thrifts to fail and left taxpayers with an exorbitant bill.

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[1] Title XIII of the Housing and Community Development Act of 1992, Pub. L. No. 102-550, 106 Stat. 3672.

The stability of the banking system was also in question. Between 1980 and 1994, more than 1,600 banks failed or received financial assistance from the FDIC. Many of these losses were associated with rapid growth and unsound speculative real estate lending. Exacerbating the situation, exams of many banks became infrequent in the early and middle 1980s. In addition, bank regulators did not adopt uniform capital standards covering all federally regulated banks until 1985, and did not adopt any form of risk-based capital until 1990.

Some of those weakened banks were so large that regulators decided to avoid liquidation for fear of damaging public confidence in the banking system as a whole. In 1984, such concerns led the FDIC to prop up Continental Illinois after it began to experience enormous withdrawals of foreign deposits in a high-speed electronic run. Again in the early 1990s, regulators quietly intervened to help avert another major bank failure, exercising veto power over every significant decision made by bank management until business restructuring and the Federal Reserve's lowering of interest rates restored financial health.

Simply stated, the troubled banks and thrifts of the 1980s and early 1990s reached a crisis point because of the weakness of their regulatory regime and the riskiness of their lending activities. This is precisely why Fannie Mae will never be the source of such a crisis. Congress ensured in 1992 that we would always be subject to rigorous safety and soundness regulation and oversight, and our investments are geographically diverse and limited to one type of low-risk and liquid asset — residential mortgages. The thrift bailout cost taxpayers $125 billion and the FDIC spent over $36 billion from the deposit insurance fund to prop up the banks. In contrast, since our privatization in 1968 — and even though we, like all other financial institutions, experienced financial difficulties in the early 1980s — Fannie Mae has never cost the American taxpayer a single penny. (Even as it suffered losses in the early 1980s, Fannie Mae never became insolvent on a generally accepted accounting principles basis.) Indeed, Fannie Mae helped mitigate the effects of the thrift crisis by consistently maintaining liquidity in the mortgage market.

Congress responded to the problems of the banking and thrift systems in the 1980s and early 1990s by enacting sweeping reforms in 1989 (the Financial Institutions Reform, Recovery and Enforcement Act of 1989, or FIRREA) and 1991 (the Federal Deposit Insurance Corporation Improvement Act, or FDICIA). These reforms addressed the need to identify possible problems early on through increased supervision and examination and to deter risky behavior through risk-based capital and risk-based deposit insurance premiums.

With the lessons of the thrift and bank crises still fresh and with the reforms enacted in FIRREA and FDICIA as a context, Congress turned in 1991 to the housing government-sponsored enterprises (GSEs). Congress recognized the public policy successes of Fannie Mae and Freddie Mac as well as the consumer and market benefits that our companies produced. Most important, Congress wanted to ensure that as many homebuyers as possible were served by Fannie Mae's and Freddie Mac's role in the market, that the companies were regulated effectively, and that the companies maintained

the financial soundness to fulfill their housing missions through varying economic conditions.

Two years of hearings, the preparation of many government studies, and committee consideration covering numerous mission, capital and enforcement proposals, ultimately produced the 1992 Act. In crafting and enacting the 1992 Act, Congress reassessed the benefits, restrictions, and obligations of Fannie Mae and Freddie Mac and the safety and soundness regulation needed to ensure fulfillment of the companies' responsibilities to consumers and the housing market. The result is a complex and interdependent set of benefits and responsibilities that maintains the critical role of private equity capital and private management, allows Fannie Mae to link more efficiently than ever the international capital markets with the U.S. housing finance market, and, at the same time, requires the company to serve affordable housing and homeownership needs throughout the country. The critical role of private equity capital and private management were maintained in the legislation.

In this way, Fannie Mae's Congressional charter is a "compact" — an agreement between private investors and the Congress. By investing in Fannie Mae, our shareholders provide capital to a company upon which Congress has conferred a structure and business purpose aimed at furthering the public policy priority of homeownership. As part of this compact, Congress gave Fannie Mae and Freddie Mac certain benefits and tools paired with certain restrictions, including limiting these companies to a single line of business — the residential mortgage market within our loan limits. Congress also reinforced the nature of our relationship with the federal government, requiring the explicit "non-guarantee" that appears on the front of every debt and mortgage-backed security. The work that Congress did in 1992 was a reaffirmation of this compact, the success of which is evident across America today.

The mandate of the 1992-revised charter is summarized in the purposes set forth for Fannie Mae:

- To provide stability in the secondary market for residential mortgages;

- To respond appropriately to the private capital market;

- To provide ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing; and

- To promote access to mortgage credit throughout the Nation (including central cities, rural areas, and underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing.

The 1992 Act is a Clear Success

In every area of concern that Congress addressed in 1992, the record of the last eight years has been one of remarkable achievement. Since the 1992 Act, Fannie Mae's performance — in terms of our housing mission, our safety and soundness, providing liquidity and stability in the market, and delivering and fostering innovation — is a clear succcess story.

Housing Mission

Ensuring Fannie Mae's continued focus on affordable housing and affordable homeownership was one of the main objectives of the drafters of the 1992 Act. Congress determined that Fannie Mae should vigorously reach underserved markets. Fannie Mae's response to this challenge was particularly dramatic, even though the company's efforts to reach more low- and moderate-income borrowers had already begun. For Fannie Mae, expanding access to affordable homeownership for more borrowers throughout the country is much more than a regulatory requirement. It is what we as a company and as a business are all about. As I have said on many previous occasions, expanding homeownership and affordable rental housing is good public policy and good business.

My predecessor, Jim Johnson, embraced this philosophy when he announced, in 1994, Fannie Mae's Trillion Dollar Commitment. This commitment was a pledge to invest $1 trillion to serve 10 million underserved families — including low- and moderate-income families, minorities, new Americans, residents of central cities and rural areas, and people with special housing needs — by the end of 2000. This promise transformed our company. In 1993, just over 31 percent of our single family business served borrowers with incomes at or below the area median. In 1999, this percentage was over 40 percent. **[CHARTS 3 & 4]** In 1999, 68.6 percent of our total business served families targeted in this initiative, and over 500 of Fannie Mae's 3,900 employees work full-time on affordable housing. **[CHART 5]** The result has been a strong focus on overcoming the barriers to homeownership. Through product innovation, underwriting experimentation and flexibility, and technology, Fannie Mae achieved greater efficiencies, lowered mortgage costs, created easier access to financing, and revitalized communities. I will mention a few brief examples:

- In partnership with Holy Name Housing, NuStyle Development, and the Equity Fund of Nebraska, and the City of Omaha, Fannie Mae has an $800,000 equity investment in 40 single-family homes, which are homeownership incubators. Known as Omaha Crown, this $4.5 million project is helping to maintain the historic Kountze Park neighborhood and to educate qualified families about homeownership skills. A portion of their monthly rent goes to a homeownership savings account so that after several years of affordable renting, the families are able to buy a home of their own.

- In 1991, Fannie Mae launched a new experiment in cooperation with the National Training and Information Center in Chicago to create a low downpayment mortgage with extended underwriting flexibilities. The Community Home Buyer's initiative provided a standard, secondary market product that enabled many of our lender partners to begin offering significant volumes of low downpayment mortgages, targeted to low- and moderate-income families and those living in underserved neighborhoods. Since the introduction of the Community Home Buyer suite of products, Fannie Mae has built a portfolio of about $50 billion in these mortgages, and created a standard that is used by lenders throughout the country.

- In 1998, Fannie Mae launched a unique partnership with the Self Help Venture Fund of North Carolina, one of the nation's foremost community development financial institutions, and the Ford Foundation to finance up to $2 billion over five years in home loans to 35,000 minority and low-income home buyers nationwide. Fannie Mae is providing a low cost secondary market outlet that provides liquidity for a market segment that in the past has relied more heavily on portfolio lending by depositories. This unique risk sharing arrangement gives us the opportunity to work with others to transform risks in the market to provide new and tangible benefits to consumers. To date, through this initiative, we have financed nearly $500 million in loans to reach traditionally disadvantaged groups as reflected in the demographics of the borrowers: 24.9 percent African American, 7.4 percent Hispanic, 38 percent female-headed household, 4.6 percent rural with an average income, as a percent of median, of 70 percent.

As many of you know, I announced earlier this year that we met the goals of the Trillion Dollar Commitment in April, eight months early. Not wanting to rest on our laurels and recognizing that much remains to be done, I also announced Fannie Mae's new American Dream Commitment — a 10-year, $2 trillion commitment to serve 18 million targeted families. This initiative will place a special emphasis on increasing homeownership among minorities, young families, women-headed families, new immigrants, and others whose homeownership rates lag the general population. This effort will also target Americans who have not fully benefited from the economic expansion of the past nine years, including many who live in economically depressed urban and rural areas.

One manifestation of Congress's emphasis on our housing mission is the affordable housing goals established by the 1992 Act. Under the statute, we are required to meet annual, percent-of-business targets in terms of our service to low- and moderate-income borrowers, to residents of central cities and other underserved areas, and to very low-income borrowers. No other company in America has percent-of-business goals as tough as the ones Fannie Mae and Freddie Mac must meet.

Fannie Mae has met or exceeded each and every one of our affordable housing goals every year since 1994. **[CHARTS 6 & 7]** Here are a few snapshots that provide a perspective on our commitment to meeting both the letter and the spirit of these goals:

- In 1993, Fannie Mae provided $62.3 billion in mortgage financing for over 994,000 low- and moderate-income borrowers. In 1999, we provided $101.6 billion to serve over 1.34 million low- and moderate-income families.

- In 1996, Fannie Mae provided $36.3 billion in financing for over 534,700 families living in underserved areas, including central cities and rural areas. In 1999, the level of this business reached $65.9 billion and 790,450 families.[2]

Meeting our annual affordable housing goals has been a challenge, and this challenge will only grow. When the Federal Housing Enterprise Safety and Soundness Act of 1992 passed, Congress had set an interim low- and moderate-income goal at 30 percent of our annual purchases for 1993 and 1994. This goal remained in place for 1995. Then, in 1996, HUD published the first formal rule governing the affordable housing goals, increasing the low- and moderate-income goal to 40 percent in 1996 and to 42 percent for 1997, 1998, and 1999. Then, on March 9th of this year, HUD announced another round of proposed increases in our goals. The proposed HUD rule would increase the low- and moderate-income goal to 48 percent in 2000 and to 50 percent for the 2001-2003 period.

HUD proposes to increase our other goals. Our special affordable housing goal for business serving very low-income families or low-income borrowers in low-income areas is now 14 percent. The proposed HUD rule would increase this goal to 20 percent. And, our goal for borrowers living in underserved geographic areas, which is now set at 24 percent, would rise to 31 percent under the proposed HUD rule. We are committed to trying to reach these stretch goals. **[CHART 8]**

Although none of our housing goals specifically focuses on minority homeownership, I would like to take a moment to address this issue. Minority lending is a key part of our mission and our business, and it represents an ongoing challenge for all of us in the housing finance industry. Minority homeownership rates have grown tremendously during the 1990s, but they continue to lag the national homeownership rate. In 1993, the Hispanic homeownership rate was 39.4 percent; today it is 45.7 percent. The African-American homeownership rate was 42 percent in 1993, and today it has reached 47.8 percent. Yet, today, the national homeownership rate stands at over 67 percent, and the white homeownership rate is 73.4 percent. **[CHART 9]** Clearly, much more needs to, and can, be done — and we are committed to playing a leadership role to increase minority homeownership.

At Fannie Mae, we have long recognized that minority families seeking to buy a home and obtain mortgage credit face barriers of wealth, income, credit, information, and discrimination. Through the expansion of low down payment mortgages, innovations in credit assessments and underwriting flexibilities, as well as our support for a variety of

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[2] The goal for underserved areas first took effect in 1996.

educational initiatives, Fannie Mae has sought to break down these barriers. These efforts have borne tangible results:

- In 1993, we provided $36.8 billion in mortgage financing for over 355,000 minority families — this included $5.7 billion in mortgages for over 65,000 African-American families.

- In 1999, Fannie Mae provided $45.6 billion in housing finance for nearly 412,000 minority families, including $8.4 billion for nearly 86,000 African-American families.

These numbers reflect an increase from 1993 to 1999 of nearly 31 percent in financing for African-American homeownership, and a 16 percent increase in financing for minorities overall. **[CHART 10]** I fully expect that I will be able to report to you continued progress in Fannie Mae's service to the minority community over the coming years.

Safety and Soundness

Those who worked on the 1992 Act recognized that the housing finance system needed further assurances that our company would be able to carry out its mission in both good and bad economic conditions. They saw that the public policy benefits that Fannie Mae and Freddie Mac delivered would be only as good as our financial strength. Congress determined that, while the companies then posed a low risk of financial insolvency, more effective Federal regulation was needed to further reduce the companies' low risk of failure.

Office of Federal Housing Enterprise Oversight (OFHEO) Examination Process

The 1992 Act created the Office of Federal Housing Enterprise Oversight to monitor Fannie Mae's and Freddie's Mac's safety and soundness. Since 1994, OFHEO has been conducting regular, on-site safety and soundness examinations. The scope and rigor of OFHEO's examinations equal or exceed those to which any regulated financial institution is subject.

OFHEO's exam program closely resembles the risk-focused large bank exam programs of the OCC and Federal Reserve System. In fact, OFHEO's Chief Examiner was formerly OCC's Deputy Comptroller for Risk Evaluation and Capital Markets and also led the OCC exam teams at Chase and Citibank. Like other financial regulators, OFHEO examiners must compile and maintain an individual risk profile for Fannie Mae and Freddie Mac. The profile, which is updated continuously based on exam results, reflects each company's specific risk level as well as the quality of its risk management. The examiners also benchmark Fannie Mae's and Freddie Mac's risk-management practices against those of other regulated financial institutions.

The size of OFHEO's examination staff relative to the number of regulated entities highlights the resources that OFHEO is able to devote to its examination duties. OFHEO has 26 examiners for 2 regulated institutions — a 13 to 1 ratio. In comparison, the Office of the Comptroller of the Currency (OCC) has 1,902 examiners for 2,485 regulated entities, or about 0.75 examiners for every institution; the Federal Deposit Insurance Corporation has 1,796 examiners for 5,807 regulated entities, or 0.30 examiners for every regulated institution.

Moreover, the size of OFHEO's examination staff is comparable to the number of examiners that other financial regulators assign to large institutions. For the 28 institutions in the OCC large bank program, the OCC has an average of 12 examiners per institution. The OCC has 28 examiners assigned to Citicorp, a company that is far more complex than we are, operating as it does around the world and in a broad range of activities. The Federal Reserve has approximately eight examiners assigned full-time to Chase.

Also important is the transparency of OFHEO's examinations and oversight. Congress requires public disclosure of summary findings in OFHEO's Annual Report to Congress. While OCC, OTS, and the Federal Reserve also issue annual reports, only OFHEO reports individual companies' exam results to the public. In reporting its 1998 exam results, OFHEO wrote that "the 1998 examinations found both Enterprises to be financially sound and well managed" and that "the results of the 1998 examination show that in all categories, Fannie Mae exceeds safety and soundness standards."[3]

In 1997, at Chairman Baker's request, OFHEO contracted with S&P to rate Fannie Mae and Freddie Mac on their risk to the government. Both companies were given a AA- rating. Fannie Mae's AA- rating was an improvement from the A- rating that S&P gave us in 1991. S&P cited our consistently strong profitability and our improvements in hedging, especially our ability to weather changing market conditions and interest rate environments. There are only six bank holding companies with a AA- rating. Some of the best known companies such as Bank of America and Wells Fargo have lower ratings.

Minimum Capital Standard

The 1992 Act requires that Fannie Mae meet a ratio-based minimum capital standard as well as its stress-test requirement. Under this leverage requirement, we must have capital equal to 2.50 percent of on-balance sheet assets. We must also hold capital equal to 0.45 percent for off-balance sheet assets. Fannie Mae must meet this minimum capital requirement using "core capital" — common stock, perpetual noncumulative preferred stock, paid-in capital and retained earnings.

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[3] *1999 Report to Congress*, Office of Federal Housing Enterprise Oversight, June 15, 1999, pp. 11, 18.

Risk-Based Capital Standard

Congress also set in place a forward-looking capital standard for Fannie Mae. This Subcommittee — and Chairman Baker in particular — has devoted significant time and energy to oversight of OFHEO's implementation of the risk-based capital standard in the 1992 Act. We believe that a great deal of progress has been made over the seven months since Director Falcon has taken the helm at OFHEO. We hope and expect that this will continue as the regulatory process moves forward. We would like to see the final risk-based capital standard in place as soon as possible.

The risk-based capital standard requires Fannie Mae to be able to withstand extremely severe economic conditions that are far more severe and persist far longer than those of the thrift crisis in the 1980s. As stated in the statute, the standard requires each company to hold enough capital to withstand a 10-year stress period characterized by unprecedented interest rate movements and credit losses occurring simultaneously. The standard is truly extraordinary, and Fannie Mae and Freddie Mac are unique in having to meet such a test.

- The credit stress component takes the worst regional economic environment in the U.S. in the last 20 years and extends it across the entire country for a full 10 years. That downturn was the recession in the oil patch in the 1980s. To get comparable conditions across the entire country would constitute an economic disaster comparable to a major nationwide depression in effect for a period of time longer than this country has ever witnessed.

- Not only does the stress test envision a ten-year period of nationwide depression but it couples it with dramatic and sustained changes in interest rates. The interest rate stress scenarios call for interest rates to rise or fall up to 600 basis points and remain at that level for 10 years. The market currently estimates that these interest rate changes are extremely unlikely. The possibility of these two credit and interest-rate scenarios happening simultaneously is vanishingly small. Nonetheless, to demonstrate the robustness of our risk-management techniques, we are measured against a confluence of highly unlikely events.

- Our risk-based capital standard requires us not only to have sufficient capital to maintain solvency throughout both events while doing no new business, but also to maintain a 30 percent capital cushion over and above these stresses. Therefore, we must maintain 130 percent of the capital necessary to survive the stress period.

OFHEO is in the final stages of promulgating regulations to implement the standard in the 1992 Act, but Fannie Mae designed its own stress test from the specifications in the statute in 1993 and has complied with that risk-based capital test ever since.

In developing our risk-based capital requirement, Congress sought to tie closely our capital to the specific risks of our business. Furthermore, the standard set out in the

1992 Act is an explicit rejection of the leverage and traditional "risk-based" ratios to which other financial institutions are subject. Unlike our risk-based capital standard, traditional leverage requirements do not adequately contemplate or measure all types of risk and impose a "one-size-fits-all" standard on sophisticated institutions operating in technologically advanced markets. Furthermore, bank capital requirements are not based upon the quantification of risk under protracted stressful interest-rate and credit conditions. Rather, their regulatory risk-based minimums derive from arbitrary formulas using only four credit risk categories.[4]

Improved Interest Rate Risk Management

Fannie Mae's approach to debt issuance gives us the ability to match, in a very wide range of interest rate environments, the cash flow we receive from the mortgages we buy with the payments we have to make on the debt funding those mortgages. The basis of our strategy is to invest in mortgages and issue debt securities that are matched in duration and perform similarly in different interest-rate environments. We are continually assessing the sensitivity of our portfolio to changes in interest rates and rebalancing the portfolio in the context of a well-defined risk-management process and strict limits imposed by our Board of Directors. As part of this strategy, we use option-embedded instruments such as callable debt and option-based derivatives. Long-term callable debt locks in lower-cost funding if interest rates rise, and Fannie Mae can call the debt prior to maturity if interest rates fall and the mortgages funded by the debt prepay. Off-balance sheet derivative financial instruments, such as interest-rate swaps, also protect Fannie Mae against losses caused by swings in interest rates.

In 1981 and 1982, Fannie Mae suffered substantial losses because of dramatic changes in interest rates that raised its borrowing costs. The interest rate environment caused similar problems for thrifts and banks. At that time, Fannie Mae had a significantly shorter liability structure and made far less use of callable debt, interest rate swaps, and other hedges to protect it against swings in interest rates.

Today, Fannie Mae is far safer than it was twenty years ago, in part because of our greater use of option-imbedded funding instruments. Indeed, if the interest rate scenario of the early 1980's were repeated today, Fannie Mae would not only avoid substantial losses — we would continue to show strong earnings. In 1990, option-based instruments were 10 percent of our mortgage assets. Other financial institutions either choose not to or are unable to use option-based funding instruments to the same extent as Fannie Mae. In 1999, Fannie Mae issued $93 billion in long-term callable debt, compared with less than $1 billion in such debt issued by the largest bank holding companies.

In 1999, the gross revenue available to us from mortgage financing was $8.1 billion. But because we chose to spend $4.6 billion to hedge the interest rate risk on those mortgages by extending our liability durations, issuing callable debt, and

[4] See A New Capital Adequacy Framework, Consultative Paper, Basel Committee on Banking Supervision, Basel Committee (1999)(hereafter "Basel II"); available on the Internet at www.bis.org/publ/bcbs50.pdf.

purchasing option-based derivatives, the amount we actually booked as revenue was $3.5 billion. That is a concrete commitment to risk management that few, if any, other mortgage investors can match. Fannie Mae incurs two types of costs to hedge its interest rate risk. The first is the cost of funding with longer-dated liabilities to create a duration match to the mortgages we buy. The second is the cost of adding optionality to our liabilities, either in the form of callable debt or option-based derivatives.

Through callable debt and other hedges, Fannie Mae protects itself from changes in interest rates. We routinely test the performance of our portfolio under adverse market conditions. Even if the 10-year Treasury rate were to move up or down by two standard deviations over the next six months — movements that cover 95 percent of probable interest rate changes — and then fluctuate randomly after that, our net interest income would vary only slightly over 2000-2003. And, indeed, despite interest rate swings of almost 5 percentage points during the 1990s, Fannie Mae experienced consistent double-digit growth in operating earnings — powerful evidence that our interest rate risk management strategy is sound and effective. **[CHART 11]**

Improved Credit Risk Management

Fannie Mae manages credit risk by using sound underwriting guidelines to determine which mortgages we will buy or securitize, by paying close attention to loans with a higher risk of default, by monitoring the performance of those who service loans held by Fannie Mae, and by sharing risk across a broad range of structures and partners. Over the past three years, Fannie Mae has made strategic investments in new credit risk management tools, creating the finest mortgage credit risk management capabilities of any financial institution. These investments – coupled with a strong economy and robust housing market – have yielded dramatic results. Fannie Mae's credit losses have plunged to a very low 1.1 basis points of our outstanding book, from $367 million in 1995 to $125 million in 1999. **[CHART 12]** Specifically:

- 1999's credit losses of $125 million were the lowest dollar losses since 1984, when Fannie Mae's book of business was one-tenth its current the size.

- 1999 marked the third consecutive year of declining credit-related expenses.

- The $1.2 trillion in mortgages we owned or guaranteed last year generated a total of $400 million in gross credit losses, but Fannie Mae took only $125 million of those losses (the rest were borne by risk sharing partners such as mortgage insurers). Approximately $1.8 billion of gross revenue in 1999 went to Fannie Mae's credit risk sharing partners, providing Fannie Mae with significant protection against credit losses.

- In 1999, Fannie Mae's single family credit losses were 1.1 basis points of average assets compared with bank credit losses of 61 basis points of average assets. **[CHART 13]**

Additionally, over the past four years, Fannie Mae has instituted a variety of loss mitigation efforts aimed at identifying and assisting borrowers who, for one reason or another, are in danger of having their homes foreclosed upon. Our Risk Profiler technology enables servicers to predict with great precision which delinquent borrowers are likely to catch up on their payments and which ones need immediate intervention. In 1999, for the first year ever, more than half our delinquent loans were resolved without a costly foreclosure because we had servicing consultants on-site working every loan with our major loan servicers. The combination of advanced technology and human judgment allowed 44 percent of our delinquent loans in 1999 to be resolved with consumers not losing their homes. For those loans where foreclosure is unavoidable, we have lowered costs and helped home values by selling properties quickly.

Liquidity and Market Stability

The rigorous safety and soundness structure created by the 1992 Act and our credit risk and interest rate risk management efforts are aimed at ensuring our constant presence in the market in every community through good and bad economic times. Our charter mandates that we fulfill this role as a market stabilizer, and we have consistently demonstrated our ability to fulfill this obligation.

At times of financial crisis, or when there is a high level of mortgage originations, demand for mortgages frequently does not keep pace with supply. At those times, we can sell debt securities and use the proceeds to buy mortgages. In this way, we can expand the financing available to mortgages and help reduce mortgage rates by increasing demand. Our purchases provide two additional important benefits to consumers in addition to lowering mortgage rates: (1) they reduce the ***volatility*** of mortgage rates; and (2) they provide ***stability*** to the flow of mortgage funds.

We serve this role especially well during financial crises. The most recent significant crisis was in the fall of 1998 when the commercial mortgage market dried up and even some sovereign nations found themselves unable to borrow. Homebuyers, on the other hand, enjoyed uninterrupted access to affordable housing finance. The reason for this "privileged" position of homebuyers is clear. As *Grant's Interest Rate Observer* noted: "It was the extraordinary purchases by Fannie Mae and Freddie Mac...that righted the...market."[5] Similarly, the *Wall Street Journal*, referring to Fannie Mae and Freddie Mac, explained: "Their presence helps to keep the market liquid and mortgage rates reasonable."[6]

Similarly, in 1994, there was a rise in interest rates that caught many leveraged debt holders by surprise. Yet through this upheaval, Fannie Mae provided stability and maintained liquidity in the residential mortgage market — even as other markets were in turmoil — by increasing our mortgage purchases and debt issuance.

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[5] Grant's Interest Rate Observer, May 7, 1999.

[6] Wall Street Journal, October 29, 1998, p. C1.

Reducing volatility is valuable in and of itself, as borrowers are not subject to such large swings in mortgage rates. But volatility also affects mortgage pricing – the greater the volatility, the higher the rate investors will charge borrowers. As a result, reducing volatility also reduces mortgage rates. First Manhattan Consulting Group, applying sophisticated econometric techniques to a unique and comprehensive data set, is completing the first quantitative study examining this issue. Their results show that during the global financial crisis of the fall of 1998, the reduction in mortgage rate volatility alone saved mortgage borrowers 33 basis points – that is a third of a percentage point.

Innovation

Expanding homeownership opportunities for underserved families and meeting the needs of our primary market partners require that we develop new products and new business processes and bring these initiatives to market in real time. In the 1992 Act, Congress designed a regulatory system to address these very requirements. The new program approval provisions of the Act strike the right balance between mission oversight and the realities of our business and our industry, while avoiding micromanagement of our day-to-day operations. As Senators Donald Reigle and Jake Garn wrote recently, "Congress thought it vital that these companies be able to bring to market new products and initiatives in a timely manner and free of unnecessary micromanagement."[7]

Since enactment of the 1992 Act, Fannie Mae has had tremendous success in developing mortgage products that are extensions of its successful mortgage programs and that well serve our lender partners and their customers, the consumer. Of particular note are the product enhancements made possible as a result of our development of Desktop Underwriter (DU), our automated underwriting technology. DU evaluates specific pieces of information to help the lender make objective, informed decisions about the relative credit risk of mortgage loans, and whether those loans are eligible for purchase by Fannie Mae. DU improves lenders' efficiency, delivering time and cost savings.

Most importantly, DU has allowed our lender partners to serve more borrowers and reduce costs — savings that are passed to borrowers. More than 75 percent of eligible mortgage applicants can be approved through DU in two to three minutes, based on a reduced set of data as compared with traditional underwriting. We have been able to expand the scope of mortgage products we offer to lenders, reduce mortgage insurance requirements, stretch loan-to-value ratios, and reduce the time and costs associated with property valuation.

A recent example of products DU has made possible is our new Timely Payment Rewards mortgage for borrowers with tarnished credit histories. With this mortgage, borrowers who qualify will be able to finance their home at a mortgage rate as much as

[7] Letter to Housing and Urban Development Secretary Andrew Cuomo, April 25, 2000.

two percentage points lower than what credit-impaired borrowers typically pay, and automatically will be guaranteed a mortgage rate reduction of an additional one percentage point after 24 monthly payments without a delinquency. This option gives credit-impaired borrowers a lower rate than they would get currently in the A-minus market, and gives them the chance to bring their interest rate down still more by making mortgage payments on time. This product is now in the pilot stage, and is being offered by 20 lenders throughout the country. Fannie Mae was able to launch this pilot as a result of the more sophisticated risk analysis available from DU.

We have also been an industry leader in conventional, low downpayment lending. Our Flexible 97 mortgage is a 3 percent down payment loan for home buyers who have trouble amassing funds for a down payment and closing costs and who have good credit histories. In addition, in our portfolio of community lending products, we have a 3 percent down payment Community Home Buyer's mortgage designed for low- and moderate-income homebuyers who earn no more than 100 percent of the area median household income and who have the income to handle their monthly payments but have difficulty accumulating cash for a down payment.

Fannie Mae's innovation is not limited to mortgage products. On the funding side of the business, we are constantly looking for new debt products to meet the demands of investors in the U.S. and abroad. One good example is our Benchmark Notes program, which we launched in early 1999. We recognized that, with the federal government moving toward a balanced budget, the size of Treasury debt issuances would decline. We saw the opportunity to step in to meet the needs of fixed-income investors with larger, more liquid securities issuances, conducted on a regular monthly basis. The introduction of the Benchmark Note products has drawn over 500 new investors to the market for Fannie Mae's debt.

Setting the Record Straight

Clearly, Fannie Mae's record demonstrates that we manage mortgage risk with a high degree of expertise and efficiency. This is what Congress chartered us to do, and since 1992 we have enhanced how we fulfill this obligation. Recently, some critics have argued that we somehow increase risk. These comments reflect a misunderstanding of the mortgage market and the role that we and others play. Often these comments also reflect misapprehension about certain key facts.

1. The U.S. housing finance system is safe and stable.

Compared with other forms of credit (commercial credit, credit cards, and other forms of consumer credit), mortgages are far less risky because they are secured by a very safe asset — borrowers' homes. In addition to the security of the underlying assets, the housing finance system is transparent and liquid. Mortgage risk is relatively easy for investors to value; and in the primary market, market efficiencies and the ease of entry have created tremendous competition and transparency, providing borrowers with a wide range of financing options. The secondary market's activities are similarly transparent:

Fannie Mae transforms mortgage debt into liquid, easy-to-value instruments that meet a wide range of investor demands. Moreover, the mortgage market is heavily collateralized: the average Fannie Mae borrower has 40 percent equity in their home.

Additionally, while mortgage debt in our country is growing, it is growing at a slower pace than consumer debt and at about the same rate as business debt. **[CHART 14]** In fact, the growth of mortgage debt has a very positive element: it is a sign of expanding homeownership, a product of low interest rates and a strong economy.

2. ***Fannie Mae is growing steadily based on the needs of other investors to share risk.***

Fannie Mae's growth is a reflection of the demands of the market in which we operate. Over the last decade, Fannie Mae grew as mortgage debt outstanding continued to grow. In 1990, Fannie Mae held 5 percent of mortgage debt outstanding. During the 1990s, the thrifts' share of mortgage debt declined by 13 percentage points, while the share held by Fannie Mae and Freddie Mac increased. Even so, by 1999, commercial banks, thrifts and credit unions together still held 46 percent of mortgage debt outstanding, while Fannie Mae and Freddie Mac held 17 percent. **[CHART 15]**

Between 1990 and 1997, Fannie Mae grew at an average rate of 17 percent annually, a growth rate slower than that of the largest bank holding companies during 1994 to 1997. **[CHART 16]** Our growth expanded at the end of the 1990s as rates fell to historic lows and the demand for mortgage financing increased at record rates. We do not expect history to repeat itself over the next several years, particularly as mortgage rates are on the rise. We anticipate that Fannie Mae's growth will come from a general expansion in the market and some modest shifts in market share. An examination of GSE growth that lumps all of the housing GSEs together fails to appreciate certain differences and distinctions: Fannie Mae's 1999 growth rate of 19 percent was far eclipsed by the 34 percent growth in Federal Home Loan Bank System assets, the benefits of which accrued to FHLB member depositories. **[CHART 17]**

Fannie Mae holds or securitizes 23.6 percent of mortgage debt outstanding. But in terms of revenues available for managing interest rate and credit risk, our market share is not 23.6 percent — it is far less, just under 9.4 percent. In other words, we purchase or guarantee 23.6 percent of the mortgage debt in the market, but we receive 9.4 percent of the revenues available for managing the credit and interest-rate risk on it. The difference between the 23.6 percent and the 9.4 percent is the mortgage risk we share with other partners. About one-half of the revenue available to us goes to our risk-sharing partners. This takes our revenue share down from 9.4 percent to around 4.7 percent. This is also why, of our $12.8 billion in gross revenues last year, we reported $6.4 billion net. The other $6.4 billion went to our risk-sharing partners – mortgage insurance companies, mortgage lenders through recourse arrangements, and investors in our debt securities. We shared or hedged our risks with all of these partners to bring our credit losses to a very low level.

This should answer two questions that often arise about our growth projections. Is Fannie Mae too big to grow? The answer is no, we have only 9.4 percent of the gross revenues – and only 4.7 percent of the net revenues – available in our market. And as we grow, are we taking too much risk? Again, the answer is no. Not only do we specialize in risk management on mortgages, we don't take all the risk – we share most it with others in the market.

3. ***Fannie Mae's expansion of the market is consistent with its charter.***

Some critics have claimed that we cannot grow without exceeding the limits of our Congressional charter. To the contrary, we can grow precisely because our charter directs us to expand homeownership opportunities for all Americans. Our investors choose to invest in us because of our charter and the public policy mission that Congress has charged us with fulfilling. The composition of our assets reflects our commitment to our charter. Just over 91 percent of our assets are mortgages or mortgage-related, e.g., Low-Income Housing Tax Credit investments. The remainder is mostly made up of cash and other short-term assets that we need for liquidity. **[CHART 18]**

Part of our charter mandate requires that we work to increase the liquidity of mortgage assets and to promote access to mortgage credit throughout the Nation. Through initiatives such as our $2 trillion pledge to reach 18 million underserved families during this decade we are fulfilling our mission by expanding the universe of consumers able to achieve the dream of homeownership. Homeownership rates among minorities, women-headed households and residents of central cities and underserved areas are well below the national average. The wave of immigration during the eighties and nineties will play out in this decade with more families seeking homeownership. These are the fastest growing mortgage markets, and Fannie Mae is committed to help these families achieve the dream of homeownership.

We will also grow as a company, increase the number of borrowers served by the conforming market, and fulfill our liquidity function by helping lenders to offer our low-cost conventional financing to consumers that are now being sent to higher-cost segments of the market. We estimate that about half of the borrowers today getting subprime loans are A-minus borrowers, just a notch below qualifying for our conventional financing. And many consumers are being offered FHA and VA loans when they could qualify for a Fannie Mae loan and save money. Our job is to lower mortgage costs, and by helping lenders offer consumers our low-cost loans we can achieve both our mission goals and our business goals.

4. The secondary mortgage market transforms debt — it does not add to outstanding debt.

Fannie Mae is a financial intermediary; it does not create mortgage debt. To illustrate, when the company buys mortgages originated by a lender and issues debt, Fannie Mae ***transforms*** the mortgages — which have illiquid, unrated, unpredictable

cash flows — into debt securities that are liquid, high-quality, and have predictable cash flows.

Here is an illustration of how this works. When a lender originates $1 billion in mortgages, the lender creates $1 billion of mortgage debt financed with short-term borrowing. Having made the loans, the lender then swaps the $1 billion into mortgage-backed securities, which are sold to Wall Street. The transformation of the loans into MBS and the sale to Wall Street eliminates the debt the lender took on to fund the initial loans — thus, the amount of outstanding debt is still $1 billion.

Of the $1 billion in mortgage-backed securities, Wall Street sells $160 million to Fannie Mae and the rest to other investors. The amount of debt outstanding is still $1 billion. Fannie Mae has now purchased 16 percent (or $160 million) of the original $1 billion in outstanding mortgage debt, and we fund our purchases by issuing effective long-term debt. The loans and MBS that we have purchased are now, for us, assets delivering income streams. (Wall Street firms use the proceeds from investor purchases to pay down their debt.) Thus, we have transformed these obligations into liquid and marketable assets, and the amount of debt outstanding remains $1 billion, funded by $1 billion of borrowing by Fannie Mae and others. **[CHART 19]**

Risk transformation is Fannie Mae's essential role in the system. We create mortgage products that consumers want, such as our 3 percent down payment loans. And we raise capital to finance them by creating debt securities that investors want, such as our Benchmark series. Once we purchase or securitize the mortgages, we then manage and/or disperse the credit and interest rate risk on the mortgages.

5. Fannie Mae's debt is not guaranteed by the U.S. government.

An increase in Fannie Mae's debt does not increase the indebtedness of the U.S. government. Our obligations are in no way backed by the full faith and credit of the United States government.

The 1992 Act requires that the front page of all our debt and mortgage-backed securities state that they "are not guaranteed by the United States and do not constitute a debt or obligation of the United States."[8] The market recognizes that fact by pricing our debt at yields that are far higher than U.S. Treasury yields. Our 10-year debt, for example, yields more than a percentage point over U.S. Treasury debt. If investors believed that a Fannie Mae obligation was a full-faith-and-credit obligation, the yield would be the same or virtually the same as Treasury obligations.

Nonetheless, our critics have asserted that our debt will soon be larger than the federal debt, so it is worthwhile to take a few moments here to clarify the numbers. **[CHART 20]**

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[8] See Section 1381(f) of the 1992 Act; see also Sections 314(b), (d) and (e) of the Fannie Mae Charter, codified at 12 U.S.C. sec. 1719 (b), (d), and (e).

- At the end of 1999, federal debt held by the public was $3.7 trillion and the total federal debt (including debt held by government trust funds) was $5.8 trillion. Our critics like to claim that the relevant number for federal debt is $2.7 trillion. They do this by using a figure they say is derived from Treasury and CBO, which they call "publicly held, interest-bearing Treasury debt." In determining the indebtedness of the United States, such a figure is meaningless. Congressional and Administration presentations of the federal budget always focus on two debt figures: gross debt and debt held by the public.

- At the end of 1999, Fannie Mae and Freddie Mac had $909 billion in outstanding debt and the Federal Home Loan Bank system had $543 billion in debt outstanding — for a total of $1.5 trillion. Our critics use a figure of $1.9 trillion — 28 percent off.

Our critics also like to assert that in some number of years, Fannie Mae debt will exceed that of the federal government. Since the government is paying down the publicly-held debt, of course that is true. Once the publicly-held debt is paid off, every company in America that issues debt to finance its operations will have more debt outstanding than the federal government. At the same time, consumers will still seek mortgage credit to buy their homes — and the secondary mortgage market will help lenders provide consumers with the financing they need.

6. Fannie Mae's ability to manage and transform risk makes us an extraordinarily safe institution.

Much of the misinformation that has been generated about Fannie Mae centers on the theme of our riskiness. Thoughtful examination of the way that we do our business and the way that our company is run and regulated demonstrates that Fannie Mae is one of the safest holders of mortgage risk.

First, Fannie Mae is in only one line of business, dealing with one type of asset. Our charter limits the company to the residential mortgage market serving middle-, moderate-, and low-income borrowers. In 2000, Fannie Mae's single-family loan limit is $252,700. While our business revolves around one kind of asset, our asset base comes from all regions of the country and consists of various mortgage product types, diversifying our risk and protecting us from the disproportionate impact of a regional downturn. For this reason, Fannie Mae has not suffered unsustainable losses when certain regions have experienced severe economic downturns. **[CHART 21]**

Second, our business centers on managing the risks of our assets and transforming these risks into instruments that appeal to a wide range of investors. Fannie Mae's interest rate risk management focuses on tightly matching our assets and liabilities using a mix of callable and non-callable debt and other duration matching instruments. This strategy provides us with the ability to match, in a very wide range of interest rate environments, the cash flows we receive from the mortgages we buy with the payments we have made on the bonds funding those mortgages. It also enables us to disperse the

risks inherent in mortgages among a broad range of domestic and international investors including commercial bank portfolios and trust departments, investment fund managers, insurance companies, pension funds, state and local governments, and foreign central banks.

Indeed, Fannie Mae is a safer holder of mortgage interest rate risk than banks and thrifts. Our national diversification insulates us from credit losses resulting from regional economic downturns that devastate banks and thrifts that are more geographically concentrated. And our specialized funding structures are designed expressly for mortgages and are a better match for mortgage risk than federally insured deposits and short-term debt, neither of which are consistent with mortgage maturities or perform similarly to mortgages in different interest rate environments.

- When interest rates rise, homeowners hold onto their fixed-rate mortgages that are now a bargain relative to what is available in the marketplace. At the same time, people with short-term deposits will tend to withdraw their funds because they can get better rates by investing in a new (higher-rate) instrument. The result is that the lender will have to replace the lost funds with new deposits at a higher cost.

- When interest rates fall, borrowers tend to refinance their higher-rate fixed-rate mortgages with new lower-cost mortgages. People who had made longer-term deposits keep those deposits in place since they have higher-yielding investments than are now available in the market. The result is that the lender will have lower-rate mortgages being funded by the same high-cost deposits.

Properly managing the risks of our business also means sharing and managing credit risk effectively. The efficiency and stability that we bring to the market is due in part to our ability to properly disperse credit risk among a variety of entities. We share credit risk with: the homeowner (through down payments and the subsequent equity buildup); mortgage insurance companies (our charter requires credit enhancement on all loans where the loan is greater than 80 percent of the value of the underlying property); our lender partners (through recourse arrangements); and others. Fannie Mae has $838 billion in credit loss protection, including $740 billion of borrower equity, $68 billion in mortgage insurance, and $30 billion in other recourse. To put this in context, Fannie Mae has had $285 million in average annual credit losses during the 1990s. **[CHART 22]** This credit-risk sharing, along with marked improvements and innovations in our risk management, has meant that Fannie Mae's credit losses have been declining even as our book of business has increased.

In addition, banks and thrifts engage in a range of lending activities from mortgages, auto loans, credit cards, and commercial lending, to far riskier and obscure activities. In fact, in the post Gramm-Leach-Bliley Act world, these institutions have a whole range of new business lines available to them, including merchant banking, real estate development, and insurance underwriting. These varied activities present a spectrum of risk levels to be constantly managed.

7. ***Fannie Mae is subject to rigorous safety and soundness oversight.***

Some of the recent public discussions about Fannie Mae and about the secondary mortgage market suggest that we operate without sufficient regulation. This claim ignores the regulatory regime created by the 1992 Act.

Overseeing our interest rate and credit risk management efforts is a regulatory regime that is both exceptionally rigorous and closely calibrated to the risks of our business. When Congress examined Fannie Mae's and Freddie Mac's capital and regulatory structures in 1992, it chose to put together a progressive capital standard that measures both credit and interest rate risk and that requires us to hold capital in relation to the amount of risk we take. The risk in our business stems from the cash flow variability of assets relative to liabilities. Accordingly, the correct risk management and risk oversight involves stressing absolute levels of interest rates and cash flows. That is the test that we have been managing our business to since 1993, and this is the test that OFHEO is now implementing.

No other financial institution is subject to as detailed or rigorous a capital standard as the one imposed on Fannie Mae and Freddie Mac by the 1992 Act. A Fannie Mae-commissioned study by IPS Sendero found that this standard would require a typical thrift to hold 50 percent more capital than required by the current Basle standards. Furthermore, when subject to the rigors of our risk-based capital stress test (which the company must be able to withstand for 10 years), the Sendero study found that the thrift industry would deplete its total capital base as early as year 5 or as late as year 7 of the 10-year stress period, depending upon the severity of the credit loss assumption applied. Similarly, banks would deplete their capital base in 5 to 7 years.

Congress imposed on Fannie Mae and Freddie Mac a stress test with extreme credit and interest rate conditions while other financial regulators still focused on leverage ratios. In recent years, bank supervisors have agreed on the need for substantial changes to the current leverage and risk-based formulas for banks and thrifts. There is a growing view that these prescriptive standards look backward and focus on past performance of portfolios; do not adequately measure all types of risk; allow banks to engage in regulatory capital arbitrage; and impose a "one-size-fits-all" standard on sophisticated institutions operating in technologically advanced markets.[9]

Indeed, the consensus of banking regulators on the direction of capital standards demonstrates that the 1992 Act stress test was far ahead of its time, and remains the state of the art. As Federal Reserve Chairman Greenspan commented recently:

> "In estimating necessary levels of risk capital, the primary concern should be to address those disturbances that occasionally do stress institutional solvency — the negative tail of the loss distribution that is so central to

[9] See, e.g., Remarks by Federal Reserve Board Governor Janet L. Yellen, "Recent Developments in the Financial System," Jerome Levy Economics Institute of Bard College, September 16, 1996, at 12.

modern risk management. As such, the incorporation of stress scenarios into formal risk modeling would seem to be of first-order importance. However, the incipient art of stress testing has yet to find formalization and uniformity across banks and securities dealers. At present most banks pick a small number of ad hoc scenarios as their stress tests. And although the results of the stress tests may be given to management, they are, to my knowledge, never entered into the formal risk modeling process.

Additional concern derives from the fact that some forms of risk that we understand to be important, such as liquidity and operational risk, cannot at present be precisely quantified, and some participants do not quantify them at all, effectively assuming them to be zero. Similarly, the present practice of modeling market risk separately from credit risk, a simplification made for expediency, is certainly questionable in times of extraordinary market stress. Under extreme conditions, discontinuous jumps in market valuations raise the specter of insolvency, and market risk becomes indistinct from credit risk."[10]

8. The secondary market reduces systemic risk.

In addition to our ability to closely match our assets and liabilities, our structure and our presence in the market reduces systemic risk in the housing finance market. Fannie Mae offers depositories an opportunity to lower their risk by purchasing Fannie Mae debt instead of MBS. Depositories, which lack many of the risk management advantages of long-term, option-based bonds, are able to avoid the significant prepayment risk of MBS. Our ability to use such instruments mitigates that risk substantially.

Fannie Mae's purchase and funding activities are transparent, which applies market discipline to its operations. We buy liquid, easy-to-value assets, and we sell liquid, easy-to-value debt. This dynamic makes us different from other leveraged investors, who are often involved in a wider and less transparent range of financial purchasing and funding activities.

Fannie Mae's performance during the latter part of 1998, contrasted with that of the hedge fund Long Term Capital Management (LTCM), illustrates the weakness of comparing Fannie Mae with a hedge fund such as LTCM. Fannie Mae differs from LTCM in three core aspects: the nature of our business, the scope of regulatory oversight, and the transparency of our operations. LTCM is an unregulated, highly secretive, opaque hedge fund. In contrast, Fannie Mae is a highly regulated, transparent company. LTCM sought to profit from the relative price movements of a variety of exotic investments, much of them financed with short-term debt. Fannie Mae has a narrow charter and a simple and safe product line. We hold assets to maturity, not for trading gains, and we fund them with long-term borrowing.

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[10] Remarks to the 36th Annual Conference on Bank Structure and Competition of the Federal Reserve Bank of Chicago, May 4, 2000.

In 1998, Fannie Mae was ready and willing to step into the market, when other mortgage investors could not or would not. We had the structure and the tools to substantially increase our mortgage purchases and to fund these purchases efficiently in the international capital markets. Our earnings growth was uninterrupted, and homeownership surged during this crisis, leading to what was then an all-time record homeownership rate of 66.3 percent.

In contrast, LTCM had to be rescued by a consortium of 13 banks and investment firms, at the urging of the Federal Reserve. With losses mounting in August and September of 1998, LTCM had trouble in meeting margin calls and its positions were threatened with foreclosure. A rescue was the only alternative to the collapse of the firm. While LTCM was experiencing problems, several other hedge funds also experienced difficulties. Some of those problems led to the forced sale of mortgage assets held by hedge funds. Those sales could easily have disrupted the mortgage market significantly, were it not for our portfolio. By broadening the pool of available financing to include investors in our debt, we stabilized the mortgage market and kept it in alignment with other fixed income markets.

9. Restricting bank holdings of Fannie Mae debt would increase risk in the financial system.

At the hearing held by this Subcommittee in late March, there was some discussion of whether commercial banks should hold fewer GSE debt securities as assets on their balance sheets. I would like to offer some perspective on this issue.

First, the "loan to one borrower" restriction currently in place refers to bank holdings of the debt of individual issuers, not groups of issuers. So to analyze bank holdings of GSE debt, it is necessary to disaggregate the debt issuances of Fannie Mae, Freddie Mac, the Federal Home Loan Banks and other GSE issuers.

Second, commercial banks in the aggregate are not over-invested in Fannie Mae. We estimate that the banking industry holds Fannie Mae debt equal to 15 percent of bank capital — the same limit imposed on bank lending to individual borrowers — and just 1.28 percent of total bank assets.

Finally, the largest relative holders of Fannie Mae debt are small banks. The 725 banks that hold more than 100 percent of their capital in Fannie Mae comprise only 8 percent of all banks and only 2.1 percent of bank assets. In contrast, the 20 percent of all banks that hold less than 10 percent of their capital in the form of Fannie Mae debt are the banks that control nearly two-thirds of the assets in the banking industry.

The implication of these statistics is that if policymakers decided to impose a limit on banks' holdings of GSE debt, the banks most affected would be the smallest banks — the same banks that pose the smallest threat of any systemic risk in the financial system. These banks choose to hold Fannie Mae debt — as opposed to MBS or even

unsecuritized mortgages — because they want the liquidity of mortgages but are not well-equipped to manage mortgage risk. GSE debt securities give them a high quality, highly liquid investment with predictable cash flows and a higher interest rate than Treasury securities. Forcing small banks to divest most of their holdings of such securities would likely ***increase*** the risk in the system, as these banks would need to replace GSE debt with investments less suited to their needs. For example, if these small banks replaced Fannie Mae debt with MBS, they would be taking on the prepayment risk they now avoid. As a risk transformer, what Fannie Mae does is put our access to the capital markets and our risk-management expertise at the disposal of smaller depositories.

As Thomas J. Sheehan, President of the Independent Community Bankers of America wrote recently, "GSE debt is one of a very limited number of investments that are eligible as collateral for public deposits. Many community banks would have to replace GSE investments with Treasury securities at rates that currently range from 25 to 50 basis points below comparable GSE securities. The loss in income would be passed on to public depositors and/or the banks' private customers and owners."[11]

Ironically, the largest banks do not hold a significant portion of their capital in GSE debt. Thus, a proposal to limit bank holdings of GSE debt aimed at reducing systemic risk would have virtually no impact on the largest banks — the very institutions whose failures could actually pose a risk to the health of the financial system.

The second implication is that by imposing a limit on bank holdings of GSE debt, policymakers would reduce the capital available to fund mortgages. This loss of funding would drive up mortgage rates.

10. The agency debt market is a distinct credit market.

As a result of the status it receives from its charter, Fannie Mae can issue debt in what is known as the agency debt market. This does not mean Fannie Mae is equivalent to a federal agency, or that its debt trades at yields similar to U.S. government securities. Indeed, Fannie Mae borrows at rates far higher than the U.S. Treasury and much closer to top-rated corporations.

Instead, the agency debt market refers to that part of the private capital markets that fund private entities (such as Fannie Mae, Freddie Mac, and the Federal Home Loan Banks) that carry out a specific public purpose. When the government chartered these institutions to raise private capital for a public purpose (in Fannie Mae's case, the expansion of homeownership), it helped create and give these institutions access to the agency debt market.

One way that our access to the agency market helps American homebuyers is that it allows us to reach a broader range of investors. Foreign central banks, which generally will not invest in U.S. corporate debt, will buy agency debt. In fact, foreign central banks

[11] Letter to U.S. Treasury Secretary Lawrence H. Summers, March 24, 2000.

purchase 15 percent of our debt securities — effectively increasing the capital available for U.S. mortgages and reducing mortgage rates.

One implication of having access to the agency debt market is that investors assume that the government, in chartering Fannie Mae, also has made a commitment to regulate Fannie Mae in a manner that ensures our continued ability to pursue our public mission. The 1992 Act reaffirmed the government's commitment to Fannie Mae's mission and to its safety and soundness, through the creation of OFHEO and the establishment of a risk-based capital standard.

II. Fannie Mae passes on the benefits its charter confers — and the benefits are not automatic.

The role Fannie Mae plays in the secondary market creates a clear benefit for homeowners every day. Every academic and government study ever done on this issue confirms what every consumer knows by checking the Saturday "rate sheets" in their local newspapers: rates on conforming loans are significantly lower than rates on jumbo mortgages.

How much do we lower rates? A comparison between conforming and jumbo rates over time generally shows a range of 20-50 basis points, or about one-quarter to one-half of a percentage point. Put in dollar terms, a 50 basis point rate reduction can reduce the cost of a 30-year mortgage by as much as $31,000 over the full life of the loan. Based on mortgage rates last week, a Fannie Mae mortgage saved consumers $18,700. Put another way, a loan one dollar above Fannie Mae's loan limit costs $18,700 more than a loan at or below our loan limit. These savings accrue to borrowers with conforming mortgages whether or not lenders sell those mortgages to Fannie Mae.

Furthermore, a 25 basis point rate reduction allows an additional 400,000 renter families to qualify for a mortgage on the median starter home. But even this understates the benefit we provide. Recent research has demonstrated that rates on jumbo mortgages "piggy back" off the rate reduction we bring to the conforming market. Without Fannie Mae and Freddie Mac, jumbo rates would be about 10 basis points higher.[12] Thus, the true rate reduction we bring to consumers is not the difference between conforming rates today and jumbo rates today, but rather between conforming rates today and what jumbo rates would be without us. I doubt that other holders of mortgage debt could demonstrate such quantifiable consumer benefits.

However, it would be a mistake to assume that Fannie Mae's access to the agency market automatically provides this benefit to the consumer. In fact, the impact Fannie Mae creates stems from an interplay between the benefits of the agency market, the efficiency Fannie Mae itself creates, and the role the market plays every day in providing capital to support homeownership.

[12] "The Effects of Purchases of Mortgages and Securitization by Government Sponsored Enterprises on Mortgage Yield Spreads and Volatility," draft report by The First Manhattan Consulting Group.

As I noted, Fannie Mae benefits from access to the agency market, but that benefit does not automatically translate into lower mortgage rates. The yield of longer-term agency debt is substantially above comparable Treasuries, but it is somewhat below comparable corporate debt. Fannie Mae enhances that benefit through the efficiency of its structure.

One way to demonstrate that efficiency is by examining our relatively narrow margins and low overhead. Our net interest margin is just over 100 basis points, compared with 420 basis points for major banks. Because we operate efficiently, our non-interest expense is 18 basis points, compared with banks' 300 basis points. This leaves us with an 82 basis point return on assets compared to 120 basis points for banks. These narrow margins mean that we can add to the benefit we receive from the agency market through the efficiency of our structure.

The market recognizes our efficiency and rewards it. When we issue Benchmark bonds that provide greater liquidity to the market, we are rewarded with lower yields. When the market trades our MBS, which carries no explicit government guarantee, it often sets a higher price and lower yield than Ginnie Mae securities, which do enjoy an explicit government guarantee.

Despite the daily evidence of lower mortgage rates and efficiencies that the market rewards, some continue to argue that we do not pass on the benefits of our charter, citing a 1996 Congressional Budget Office (CBO) study. That study concluded that Fannie Mae and Freddie Mac in 1995 received $6.4 billion in federal "subsidies," of which they supposedly retained $2.1 billion. In addition to its questionable methodology, the CBO study is plagued by a number of critical errors.

- CBO assumed that Fannie Mae issues debt at yields 70 basis points lower than AA-rated financial companies (and that Freddie Mac issues debt at 68 basis points lower). In fact, the debt advantage for Fannie Mae and Freddie Mac in the 1990s has averaged about 35 basis points. Correcting CBO's analysis for this error reduces the $2.1 billion retained benefit to $0.8 billion.

- CBO also produced flawed figures for MBS, reflecting a misunderstanding of how the MBS market operates. In its analysis, CBO claimed that the higher price investors are willing to pay for Fannie Mae MBS gives Fannie Mae a 40 basis point "subsidy" in its securitization of mortgage-backed securities. In fact, the higher price is paid not to Fannie Mae, but rather to the lenders with whom Fannie Mae has swapped MBS for mortgages. Fannie Mae's only income is the guaranty fee, which depends on the credit risk of the loans underlying the MBS pool, not on the market price of Fannie Mae MBS compared with private MBS. CBO valued this subsidy, which Fannie Mae and Freddie Mac never receive, at $3.8 billion. Correcting CBO's analysis for this error reduces the $0.8 billion retained benefit to a net positive $3.0 billion. **[CHART 23]**

The CBO study also includes other methodological flaws. For instance, it only credits Fannie Mae and Freddie Mac for the loans they buy or securitize, while the benefit of lower rates is felt across the entire conforming market. In addition, the impact of their activity helps pull down jumbo rates as well, which is also not reflected in the CBO analysis. Simply correcting the errors CBO made in quantifying any advantage accorded our debt or MBS erases any "retained subsidy." Correcting the larger methodological flaws demonstrates that Fannie Mae and Freddie Mac deliver a greater value to the consumer than they receive through access to the agency market.

12. Fannie Mae's service to homebuyers depends on the company's profitability.

Our pre-tax income is used for three purposes: to pay Federal taxes, to distribute as shareholder dividends, and to retain as capital to back the purchase and securitization of mortgages (subject to our strict risk-based capital standards). In 1999, 28 percent of our income went to pay Federal taxes, and another 22 percent went to pay a 1.7 percent dividend yield to our shareholders. (Our shareholders accept this low return because they know that we have an opportunity to grow, unlike a public utility that cannot grow and therefore has to pay much higher dividends to shareholders. If our shareholders decided that we did not have any growth potential, we would have to pay higher dividends, reducing the capital available for homeownership.) In 1999, we used the remaining 50 percent of our pre-tax income — $2.7 billion — to provide the capital required for the $195 billion we invested in homeownership and rental housing. **[CHART 24]**

Since 1968, when Fannie Mae became a private company, we have increased our capital from $185 million to $19 billion. That $19 billion in private capital is what keeps liquidity flowing in the conventional mortgage market, and what keeps interest rates for homebuyers as low as possible. That $19 billion in capital is what has allowed Fannie Mae to own or guarantee $1.2 trillion in mortgages for close to 16 million families.

H.R. 3703 Does not Improve on the Successes of the 1992 Act

I have spent a great deal of time today discussing the improvements and reforms set in motion by the 1992 Act. That is because I believe the 1992 Act — developed when the lessons of the S&L crisis were fresh in the minds of policy makers — got it right. It established rigorous safety and soundness requirements; it focused us more than ever on our affordable housing mission; and it created an environment conducive to innovation. This is a structure that has demonstrated value — for the market and for home buyers.

With this in mind, I would like to offer a few comments about H.R. 3703. I apply a straightforward test for examining policy proposals affecting our housing finance system:

- Does it reduce costs for consumers?

- Does it improve the safety and soundness of the housing finance system?

- Does it expand opportunities for homeownership?

- Does it allow innovation in the market without cumbersome regulatory requirements?

If the provisions of the Baker bill are enacted, homeownership will be more costly. This bill seeks to change a system that effectively links the international capital markets with the U.S. mortgage market by undoing several years of serious work by Congress and the Executive Branch. Our housing finance system is characterized by the efficiency and the predictability that comes from market discipline. H.R. 3703 calls into question the system's current predictability and its future efficiency, and consumers would pay the price of its passage.

The bill creates an inefficient and unwieldy structure and imposes a new web of regulatory requirements and burdens on our company — and hence on consumers — without enhancing safety and soundness. The benefits that consumers receive from the housing finance system are best protected and promoted by the system's continued safety and vitality. Unfortunately, despite H.R. 3703's stated objective to enhance safety and soundness, the bill could very well undermine our safety and soundness, add confusion to our regulatory structure, and impede the efficiency of the housing finance market.

The bill creates a new regulatory structure that offers nothing in the way of improved regulatory oversight, while undermining key regulatory priorities. First, the bill creates a five-member, politically divided board with ill-defined powers — a structure prone to division and delay. Although the bill purports to consolidate the regulation of Fannie Mae, Freddie Mac, and the FHLBs, the new regulator would have the cumbersome responsibility of carrying out two entirely different schemes of regulation. No attempt is made to harmonize the different capital, tax, and mission requirements under which the FHLBs operate, compared to Fannie Mae and Freddie Mac.

Second, the inevitable uncertainty of any transition would further delay implementation of the risk-based capital requirements of the 1992 Act. This would be caused not only by the problems surrounding any change so significant, but also by the broad, undirected authority in the bill for the regulator to change the risk-based standard.

Third, the bill would propose to limit our liquid investment portfolio, threatening our ability to manage our liquidity in response to market demands. One only has to look back to the market downturn in the fall of 1998 for an illustration of the centrality of our liquidity to the stability of the markets and the interests of the consumer.

The failure to improve safety and soundness is accompanied by new and unwarranted regulatory burdens. The regulatory structure set out in the 1992 Act set the stage for a tremendous amount of innovation in the housing finance system — innovation that has delivered more variety and more affordability to an ever-growing universe of borrowers, helping to increase the homeownership rate. This innovation came about

because, as discussed previously, the 1992 Act created a regulatory approval process that helped keep us focused on our mission, without micromanaging the day-to-day operations of our business.

H.R. 3703 would create a very different regulatory process — one requiring that any new product, or new business process, be subjected to a formal notice-and-comment process, with publication in the *Federal Register*. It would give to this multi-headed regulator the responsibility of deciding whether the public should have access to this new product based on a vague "public interest" standard. Such a process would be excessively slow, reveal to our competitors — and to our lenders' competitors — our proprietary product development efforts, and be unpredictable in result. It would choke off important innovation, stifling our ability to adapt with the lenders we serve in the changing mortgage market. Finally, it would directly contradict the goal of the 1992 Act to allow Fannie Mae and Freddie Mac to innovate in pursuit of our mission.

As I mentioned at the outset of my testimony, we view our charter as a compact between Congress and our shareholders. If the charter is the agreement, Fannie Mae operates under that agreement to provide private capital in support of Congress's interest in furthering homeownership. H.R. 3703 seeks to surgically adjust certain elements of this agreement, which would upset the overall balance of rights and responsibilities. The 1992 Act examined this balance and strengthened it. H.R. 3703 fails to improve any of the areas addressed or reforms put in place by the 1992 Act; indeed, it weakens the structure created by the 1992 Act.

A section-by-section analysis of H.R. 3703 is attached as Appendix A.

Conclusion

I said at the outset of my statement that Congressional and regulatory oversight of Fannie Mae and Freddie Mac are important to the vitality of the system. Such oversight takes place in the context of an international capital market that is being asked to invest billions of dollars everyday to support the U.S. housing finance system. Because these investors are making long-term investments, they deserve long-term stability in the regulatory framework of the issuer. The 1992 Act provided the type of long-term stability investors need. The Congress should be careful to not create instability by creating changes to the 1992 Act without compelling justification. Any uncertainty injected into the housing finance market will ultimately be paid for by consumers in the form of higher mortgage rates.

Thank you for inviting me to testify before you today. I look forward to working with the Subcommittee on these important issues.

Fannie Mae's business

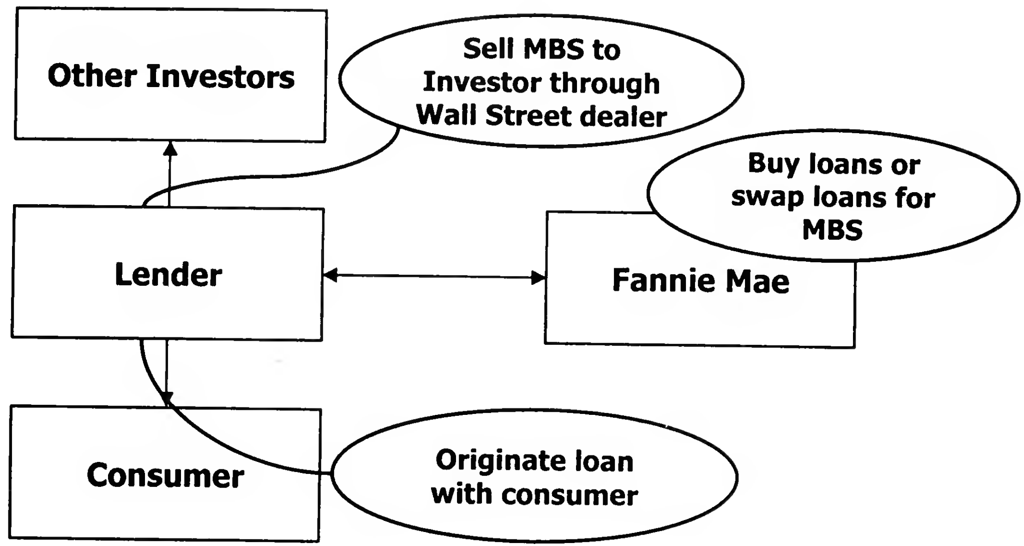


Chart 1

FannieMae.

Fannie Mae transforms fixed-rate mortgage risk to meet different investor needs

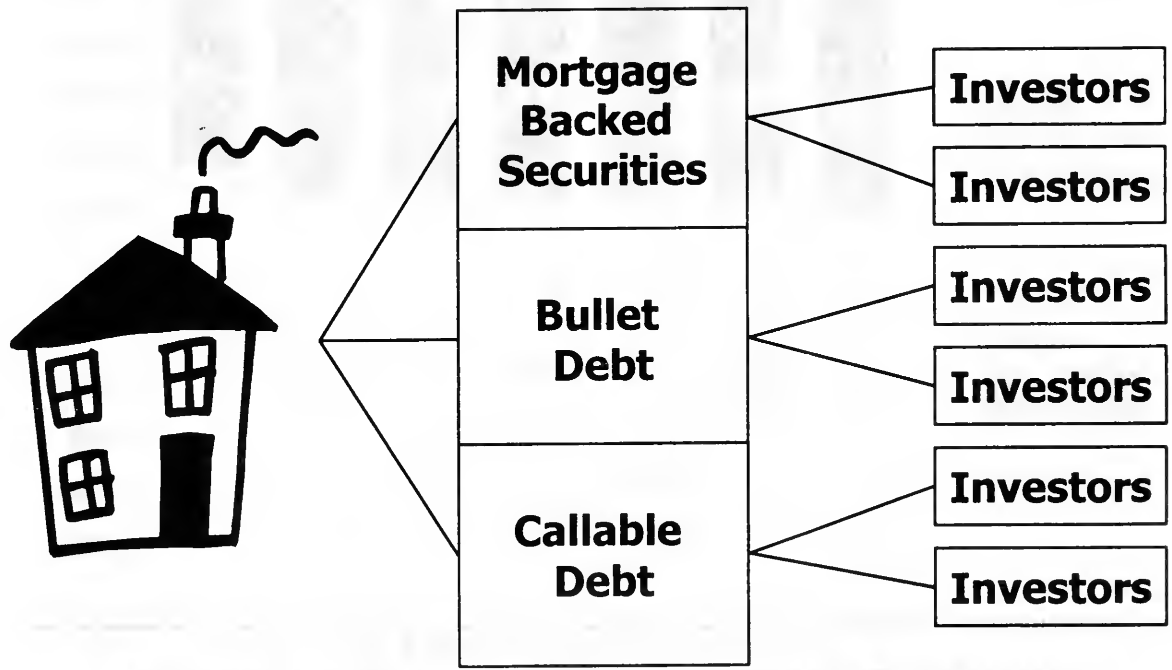


Chart 2

FannieMae.

Fannie Mae's changing business profile

All Single Family Loan Acquisitions

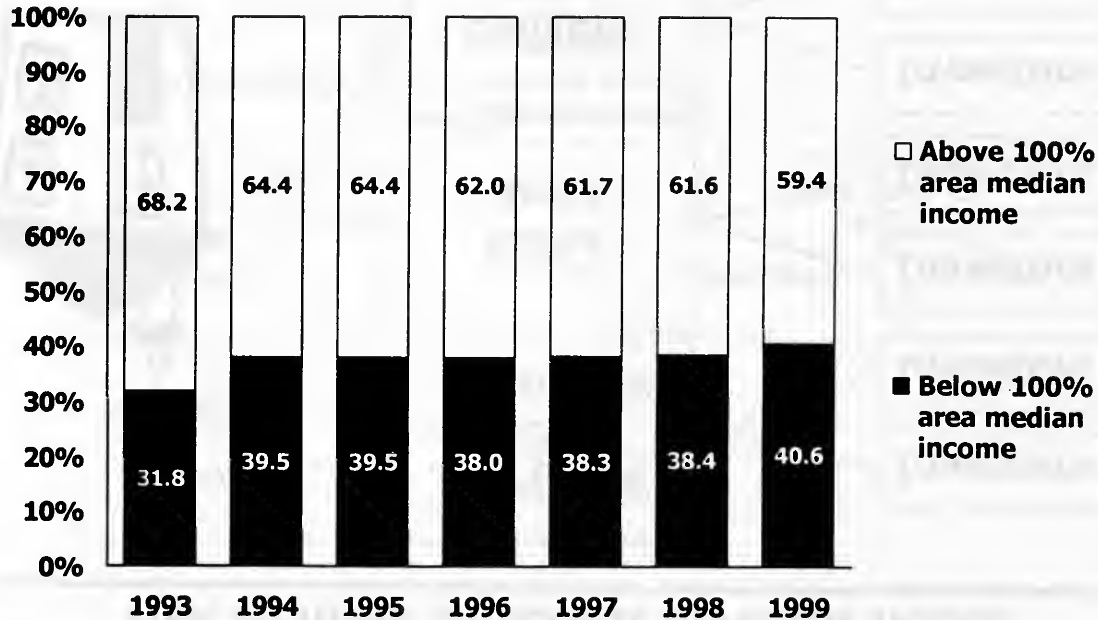


Chart 3

FannieMae.

Fannie Mae's changing business profile

Single Family Loan Acquisitions Below 100% Area Median Income

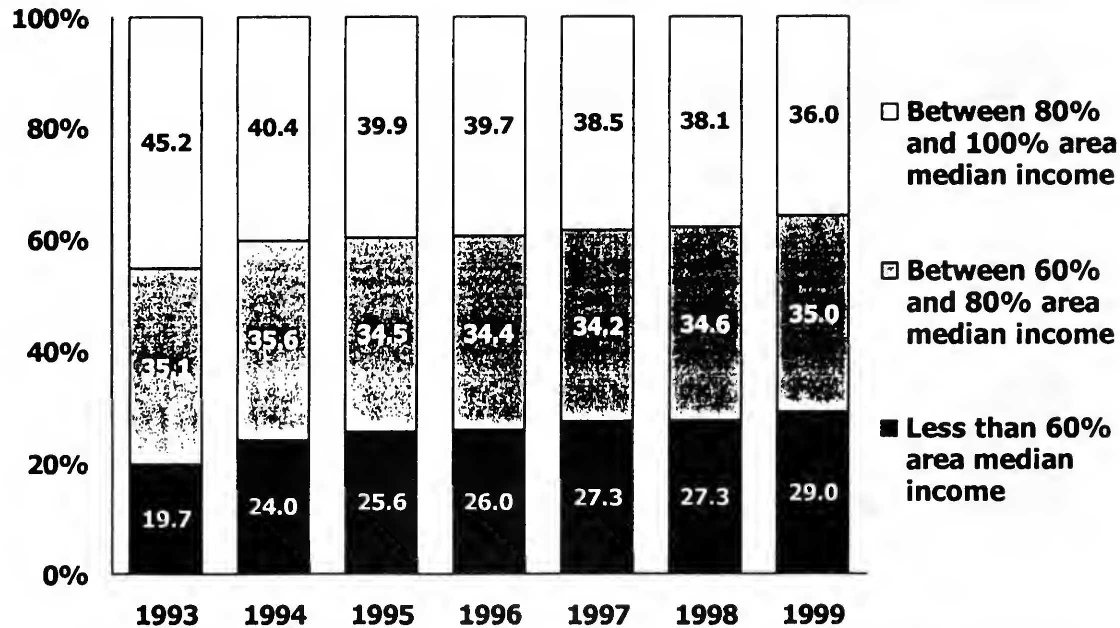


Chart 4

FannieMae.

Trillion Dollar Commitment business

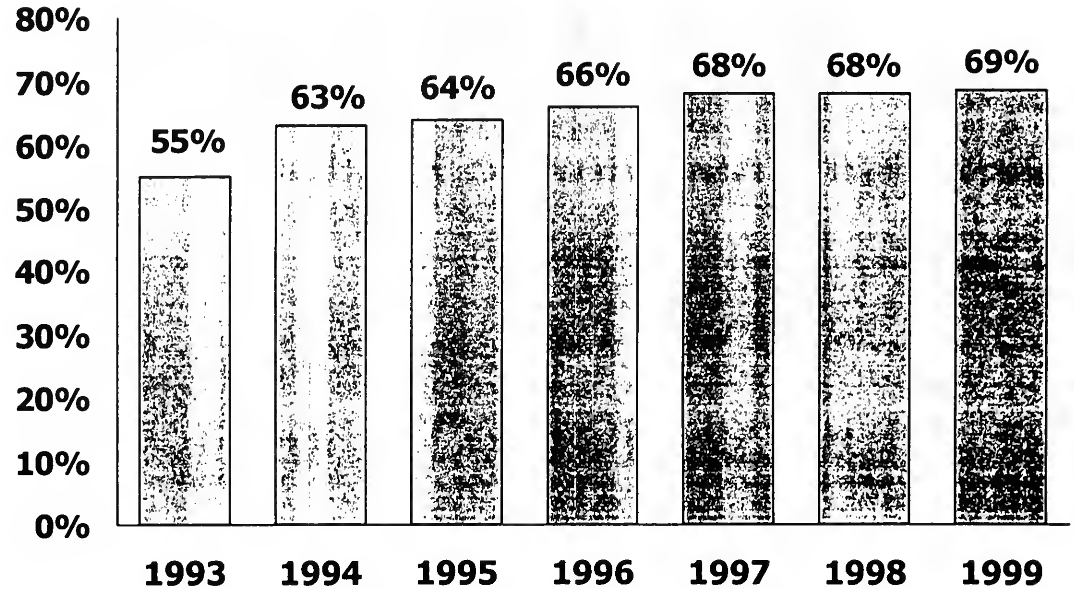


Chart 5

FannieMae.

HUD housing goals performance

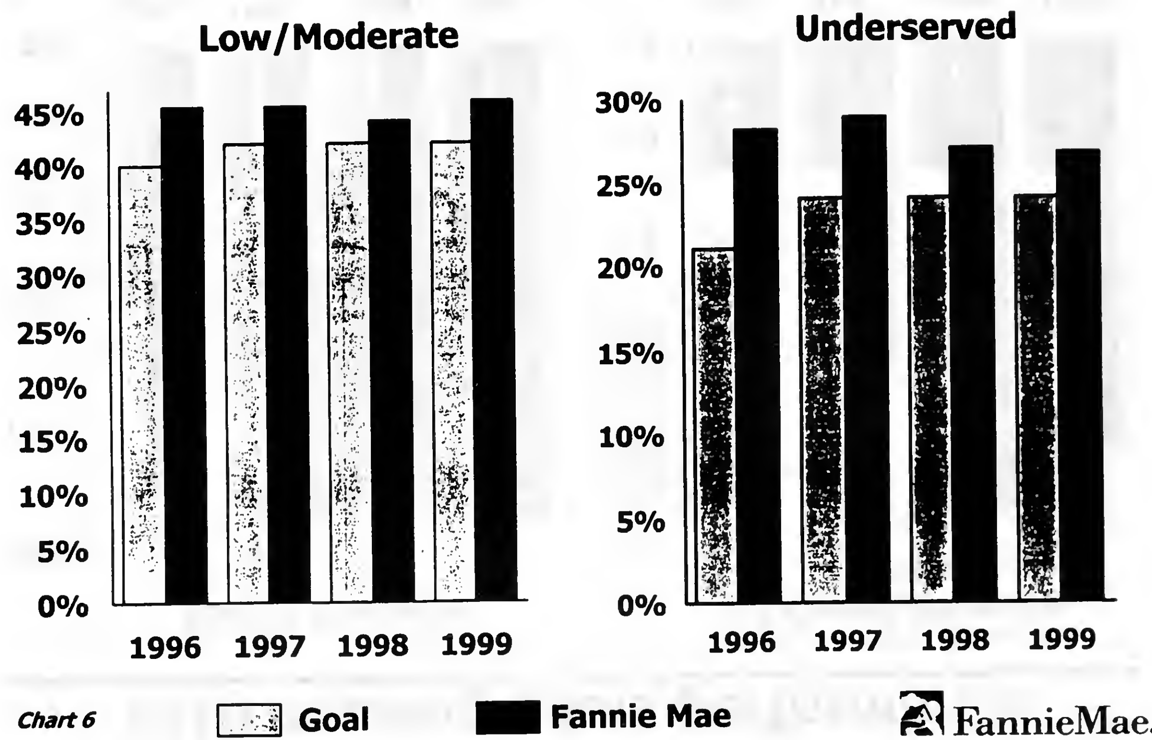


Chart 6

HUD housing goals performance

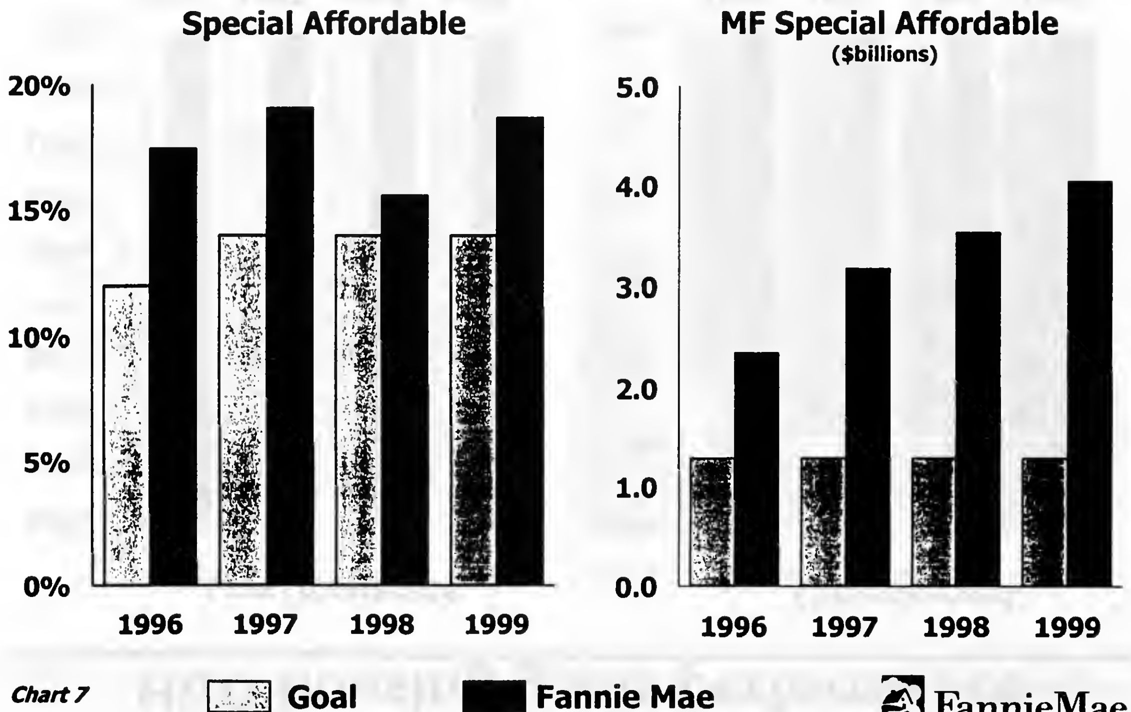


Chart 7

FannieMae.

Housing goals: Current and proposed

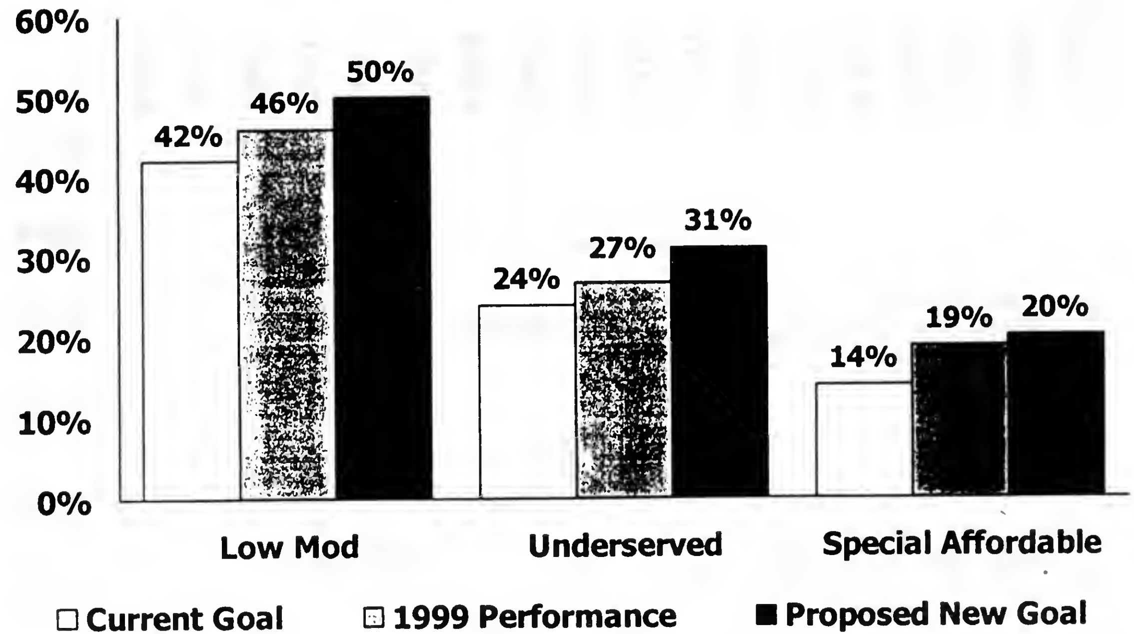
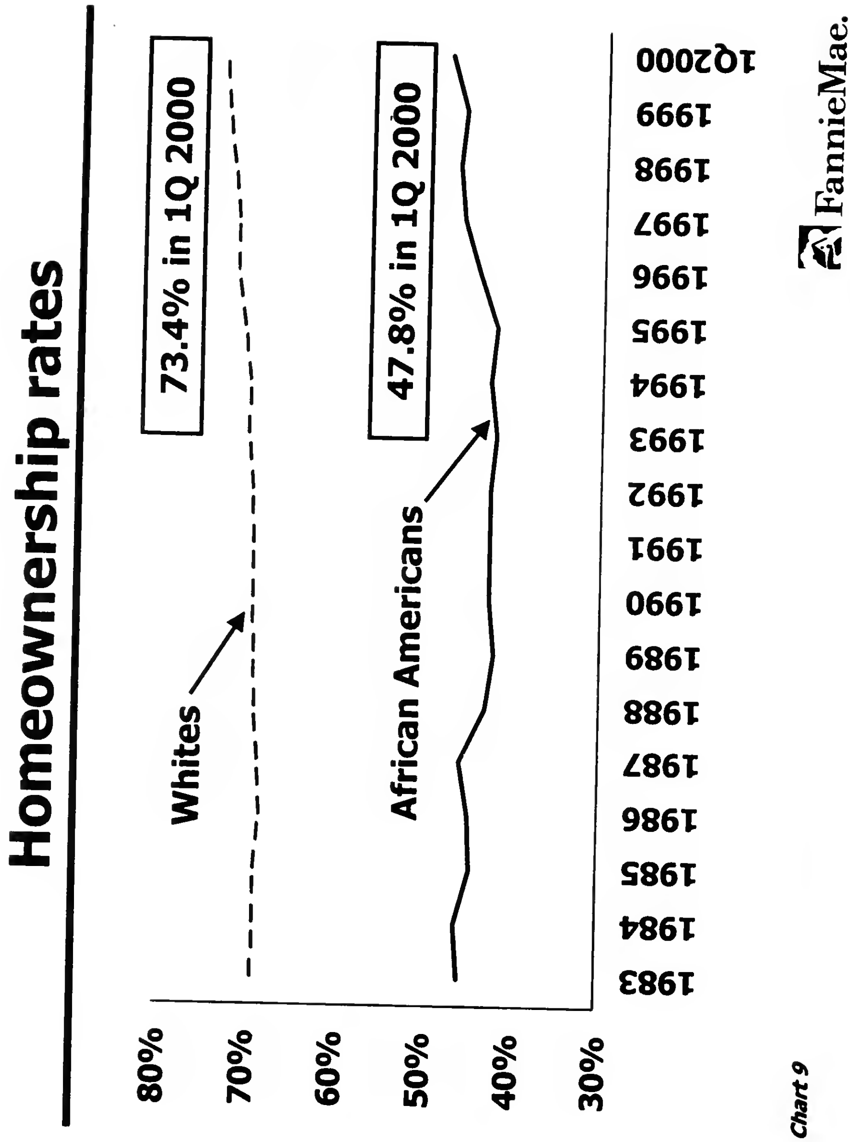


Chart 8

FannieMae.


Homeownership rates
73.4% in 1Q 2000
47.8% in 1Q 2000
Whites
African Americans
80%
70%
60%
50%
40%
30%
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
1Q2000
FannieMae.
Chart 9

Minority business

1993-1999 Percent change in households served--PMM and refinance

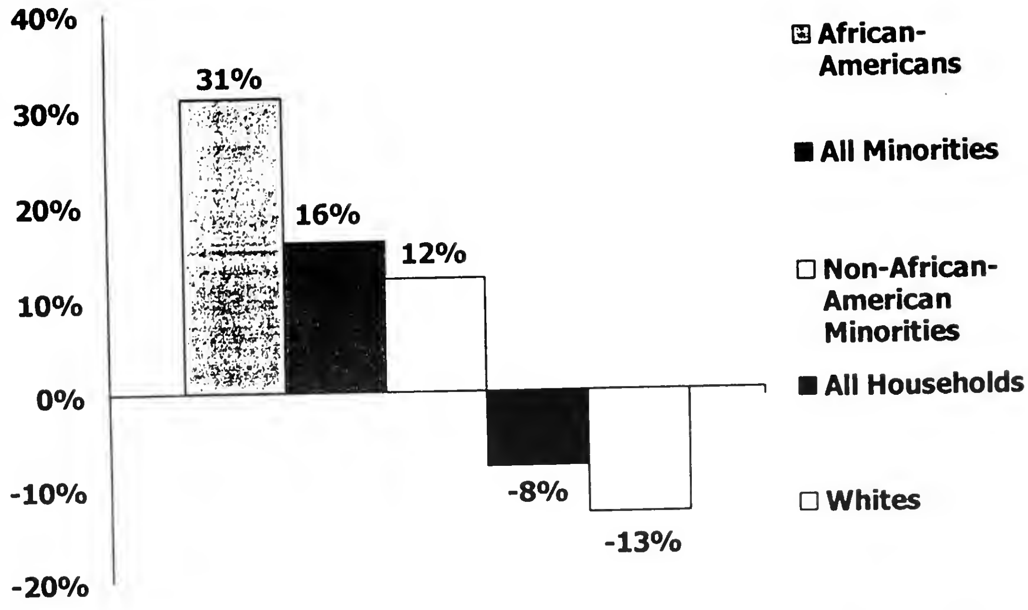
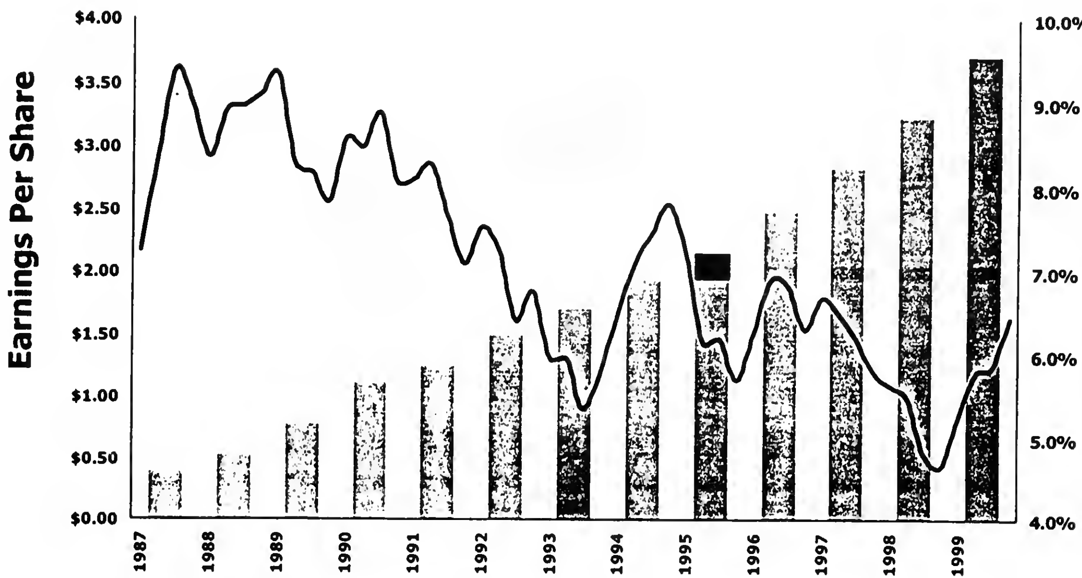


Chart 10

FannieMae.

Interest rate risk management



1995 -- $2.15 before special foundation contribution, $1.95 after special foundation contribution

Chart 11

FannieMae.

Credit risk management

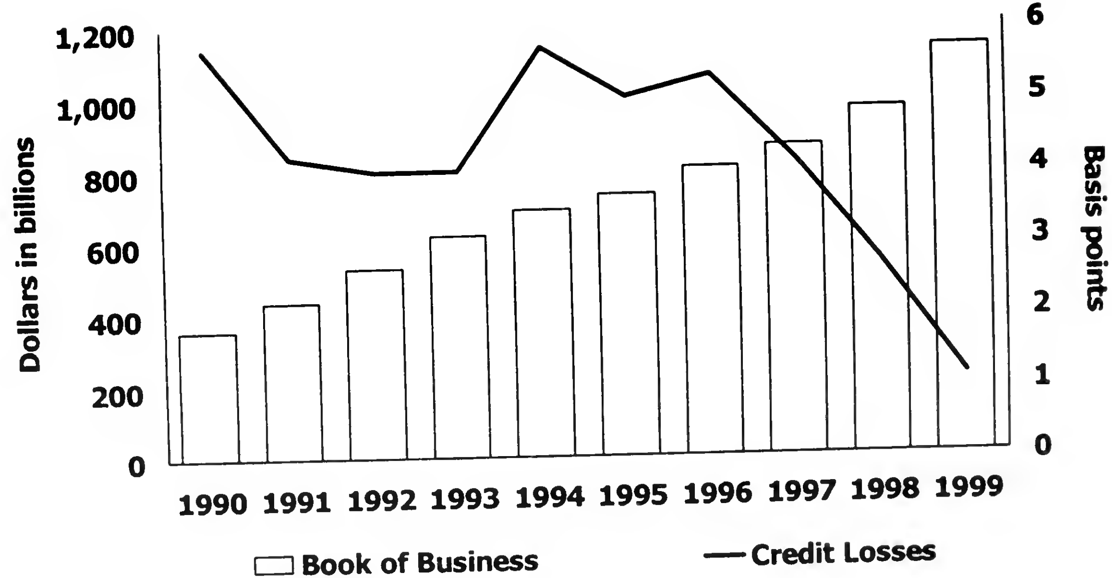


Chart 12

FannieMae.

Lower credit losses

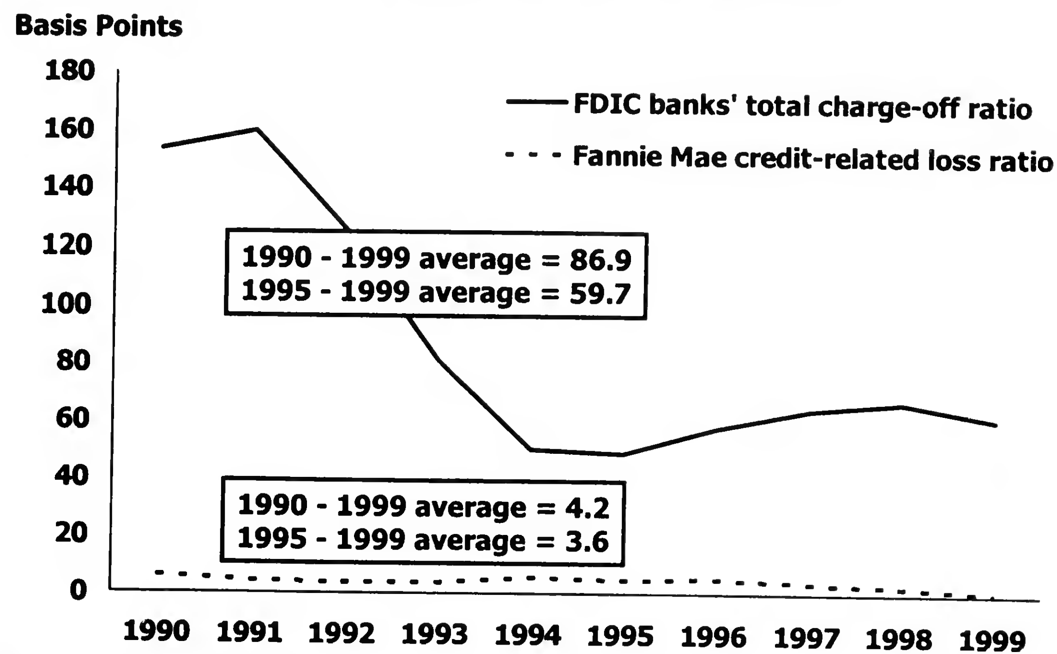


Chart 13

FannieMae.

Relative growth in debt markets

Index of growth in the U.S. debt markets (index: 1991 = 100)

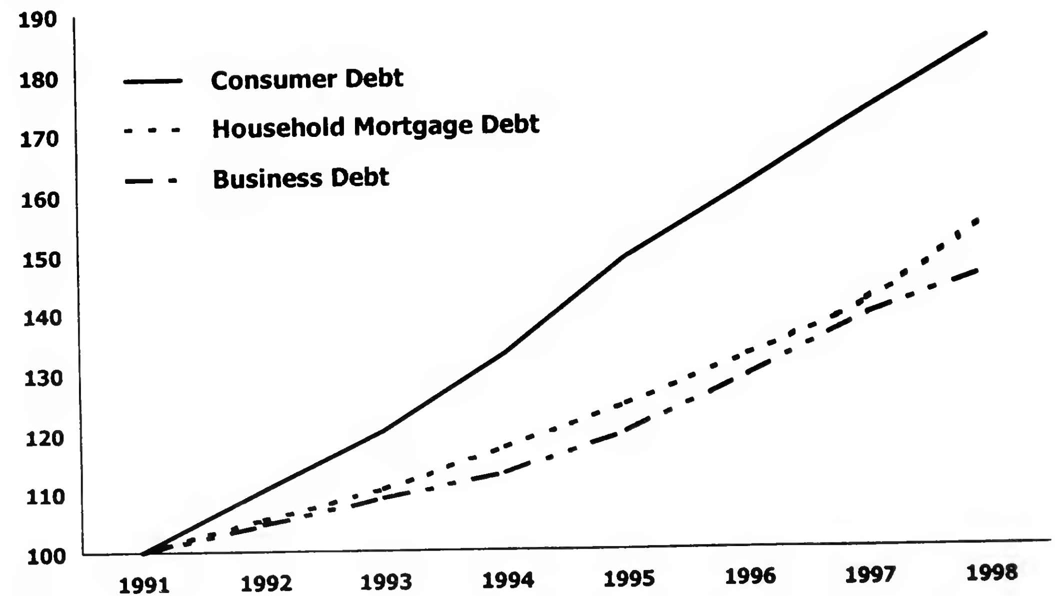
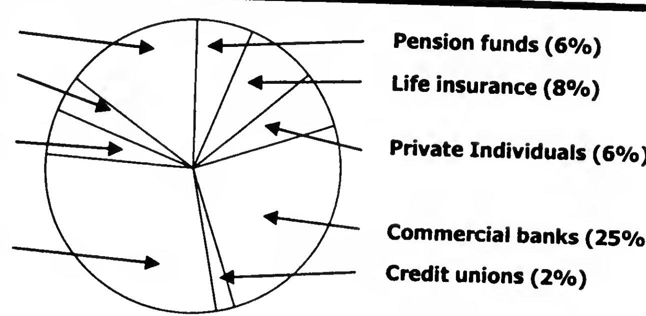


Chart 14

FannieMae.

Market share

1990



1999

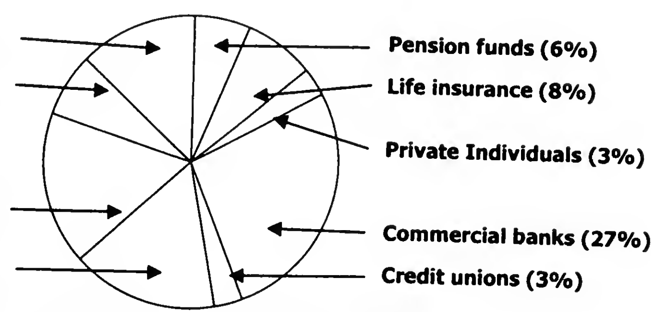
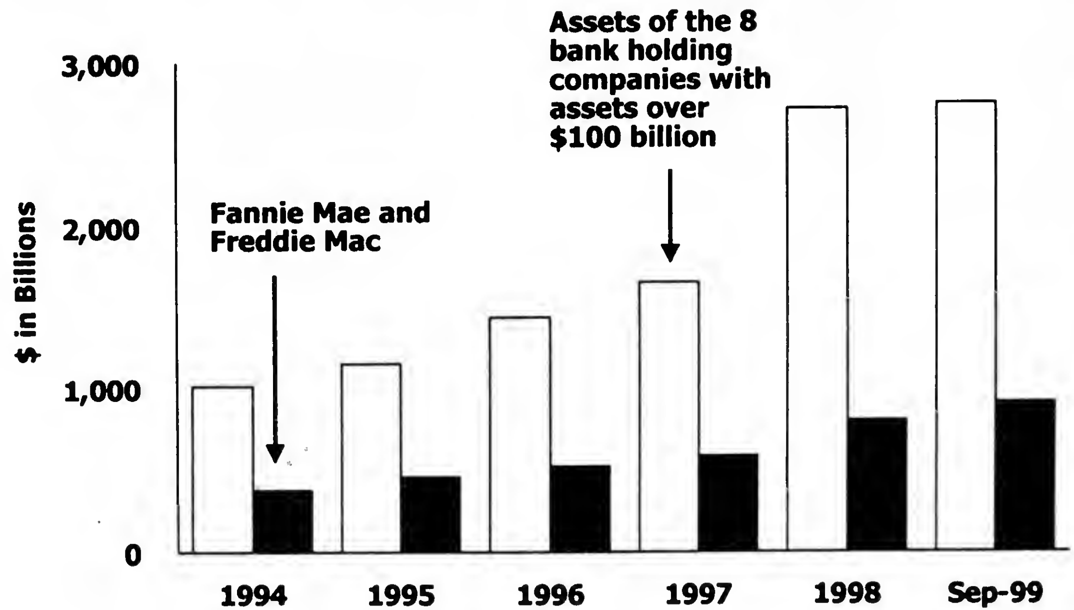


Chart 15

FannieMae.

Fannie Mae and Freddie Mac are growing more slowly than the largest banks



The 8 BHCs are Chase Manhattan, Wells Fargo/Norwest, JP Morgan, Citigroup, First Union, Bank of America, Fleet Financial and Bank One

Chart 16

FannieMae.

Appendix A

Summary of the Housing Finance Regulatory Improvement Act of 2000

(H.R. 3703 introduced by Chairman Baker (R-LA))

Title I–Housing Finance Oversight Board

Subtitle A–Improvement of Supervision

Section 101. Establishment of Board.

The bill establishes a new independent agency, the Housing Finance Oversight Board (the "Board"), as a safety and soundness and mission regulator for Fannie Mae, Freddie Mac and the Federal Home Loan Banks (collectively referred to in the bill as "the GSEs"). The Board succeeds to all of the authority of HUD and OFHEO with respect to Fannie Mae and Freddie Mac, and the Federal Housing Finance Board (FHFB) with respect to the Federal Home Loan Banks. The Board is an independent agency in the Executive branch.

The Board is composed of the secretaries of Treasury and HUD, or their designees (who also must be officials who have been confirmed by the Senate), and 3 presidential appointees confirmed by the Senate. The three presidential appointees serve terms of 6 years and are required to have "extensive experience" or "training in" housing and finance, financial institution regulation or capital markets. Not more than 3 members of the Board can be from the same political party.

One of the presidential appointees will serve as the Chairperson of the Board. The Chairperson is designated to be the spokesperson for the Board and represent the Board in its relations with the Federal government. The Chairperson is directed to serve as the chief executive officer responsible for the day-to-day responsibilities of the Board. The Chairperson is given authority to exercise all responsibilities of the Board with respect to personnel.

Vacancies on the Board will be filled in the original manner that the appointment was made. In the event of vacancies for the Secretary of HUD or the Secretary of the Treasury, the Acting Secretary will sit on the Board.

Notwithstanding that the Act does not become effective until 270 days after enactment, the President may appoint members of the Board immediately. During the period starting on the effective date of the Act and ending with the appointment and confirmation of at least two presidential board members, the Secretary of HUD and the Secretary of the Treasury shall act with full power of the Board.

Comments: Congress recently has rejected this type of regulatory structure for financial institution supervision. When the Treasury Department proposed its financial modernization bill in June 1997, a multi-headed supervisory Board for all financial institutions was considered too unwieldy and difficult to get up and running in a reasonable period of time. Congress in a similar manner rejected consolidation of the federal banking agencies into one, multi-headed institution as proposed by the Treasury Department during the 1990s. It is unclear what purpose would be served by proposing a similar type of consolidated supervisory body for the GSEs. Safety and soundness would suffer in the years it would take to accomplish the consolidation.

Moreover, it is unclear what types of individuals would serve on the Board. The two cabinet secretaries can designate an official as junior as an Assistant Secretary to sit on the Board. This in and of itself diminishes the importance of the Board. The Chairperson is given authority to represent the Board in its dealings with the Federal government. This appears inconsistent with the intent to have a checks and balances system by having 5 persons on the Board. It also diminishes the role of the secretaries of HUD and Treasury. As drafted, the bill permits presidential appointees to have very vague qualifications to serve on the Board. One would need only to be "trained in financial institutions regulation," or have

some connection to the "capital markets" in order to be appointed to the Board. The Board thus could become an amalgam of political appointees with varying degrees of the specific type of knowledge and expertise required to supervise the GSEs adequately. This is not an improvement over the current system of regulation.

The status of OFHEO, HUD and the FHFB are unclear upon enactment of the Act. The President may appoint Board members immediately, but it is not clear what happens if the members are not so appointed, since section 101(c) begins a "transition period" 270 days after enactment. From the time of the date of enactment and the beginning of the transition, it is unclear whether HUD, OFHEO and the FHFB would have authority to continue regulating the GSEs. Even during the transition provided in section 101(c), supervision will be impaired because only the Secretary of the Treasury and the Secretary of HUD have authority to act for the Board until the appointment of at least two other Board members. The system of supervision could be uncertain and highly politicized for years awaiting confirmation of at least two other Board members.

Section 102. Duties and Authorities of Board.

The "principal" duties of the Board are to ensure that the GSEs operate in a "financially" safe and sound manner, carry out their missions through activities that are authorized under, and consistent with the purposes of, the provisions of their charter acts, and remain adequately capitalized. To the extent consistent with these principal purposes, the Board's duty is to exercise general supervisory and regulatory authority over the GSEs in accordance with the Act, their chartering acts and any other provision of law.

Comments: This provision leaves the duties of the Board vague and uncertain. In contrast, current law spells out the obligations of OFHEO and the FHFB in a more comprehensive manner – in part to ensure that safety and soundness regulations will not be politicized.

Section 103. Public Disclosure of Information.

This section requires the Board, by regulation, to require public disclosure, on not less than an annual basis, of financial, business and "other information" of the GSEs that the Board determines would be in the public interest (because the availability of such information would increase the efficiency of the secondary mortgage market or the housing finance system).

Comments: This provision preempts the Federal Trade Secrets Act and allows a government agency to force private businesses to disclose trade secret information. The Trade Secrets Act carries criminal penalties for government officials who disclose protected information. This bill overrides that current protection for these three entities only and not for any other businesses. This is an anti-competitive position, contrary to Congress' posture on all other laws governing financial institutions. The standards under which the Board is permitted to require disclosures are vague and will give the Board extraordinary power to force limitless disclosure. For example, current HUD regulations implement specific standards regarding when Fannie Mae and Freddie Mac would be required to disclose confidential information of lender partners to HUD, and in very controlled instances to HUD's Public Use Database. In contrast, this very broad language allows the Board to require public disclosure of lender information and any other information in Fannie Mae's possession.

Section 104. Personnel.

This section makes the compensation provisions for the Board and its employees "subject to the provisions of Title II of the Act." This provision prohibits the Board from delegating any function to the Federal Home Loan Banks or any employee, joint office or unit thereof. The bill strikes provisions in current law that require OFHEO to reimburse HUD for reasonable expenses and allow OFHEO to appoint outside consultants and experts.

Section 105. Assessments.

This provision takes the Board out of the Congressional appropriations process.

Comments: This provision gives the Board authority to levy assessments on these three entities without any constraint whatsoever. Budgets and forecasts of the Board are not required to be submitted to Congress, as currently required of OFHEO. Because there is no regulatory competition for GSE charters, as there is in the dual banking system, there will be no check whatsoever on the power of the Board to charge excessive fees or any requirement that the Board avoid unnecessary expenditures.

Section 106. Public Disclosure of Final Orders and Agreements.

Technical.

Section 107. Limitation on Subsequent Employment.

Expands current law to apply to post-Board employment at any Federal Home Loan Bank.

Section 108. Regulations.

This section deletes a section from current law that required OFHEO to issue all regulations associated with its statutory mission within 18 months of enactment of the 1992 Act.

Comments: This provision highlights the "lag time" effect of creating new federal agencies. Eight years after its creation, OFHEO still has not issued its risk-based capital regulation -- its main function as conceived by Congress in 1992. Any new start up body will undoubtedly experience similar delays. This does not achieve the goal of improving safety and soundness regulation.

Section 109. Termination of Authority of HUD.

This provision strips HUD of its role as mission regulator for Fannie Mae and Freddie Mac. However, HUD retains its role in administering fair housing laws.

Comments: This provision transfers mission regulation for Fannie Mae and Freddie Mac away from an agency familiar with housing needs in the country and to a new, untested board that has no particular commitment to advancing affordable housing. In addition, keeping HUD's fair housing authority intact is confusing and leaves significant regulatory responsibilities with HUD. This could be a basis for significant continued regulation by HUD on a broad range of issues that will overlap with the authority of the new Board. This defeats the purpose of streamlining regulation.

Section 110. Approval of Board for New Activities.

The bill requires prior approval of the Board for a broadly defined category of "new activities," which are authorized if: (1) authorized by the respective chartering Act; (2) can be conducted, in the judgment of the Board, in a safe and sound manner; and (3) are in the public interest as determined by the Board. New activity requests by the GSEs must be published "promptly" by HUD in the Federal Register for a comment period of at least 30 days. Requests generally must be approved or denied within 90-120 days of publication in the Federal Register.

Comments: No other financial institutions are required to publish innovative business ideas in the Federal Register for public comment and public replication. In addition, the language used in this provision is so vague that any activity undertaken by the three entities could be deemed "new" by the Board. The ability to innovate would be severely hampered, as the delays allowed by this provision would be at least three to four months before any new activity or product is approved – and the Board could extend even the four month period by delaying publication of the notice under only a vague requirement that it publish the notice "promptly." This provision also gives the Board extraordinary power because it must approve a "new activity" only if the Board determines the activity is "in the public interest." This is essentially a standardless standard. This vague provision could be used in a manner that prevents these three entities from carrying out their statutory responsibilities. Thus, the bill is

internally inconsistent because Section 110 will adversely affect the missions of the GSEs despite the requirement in Section 102 that the Board ensure that the GSEs carry out their missions. It also completely changes Congress' rationale in enacting the 1992 Act -- which was to promote safety and soundness of Fannie Mae and Freddie Mac without stifling innovation or micromanaging the business of private companies.

Furthermore, these provisions define "new activity" differently for Fannie Mae, Freddie Mac and the Federal Home Loan Banks. The provisions grandfather all activities of the Federal Home Loan Banks as of 2/15/00, but only those of Fannie Mae and Freddie Mac engaged in before enactment of the 1992 legislation, or within certain dollar limits. This is contrary to the Act's express intention to streamline regulation, and defeats the purpose of consolidating regulators.

Section 111. Limitation on Nonmission-Related Assets.

This section requires the Board to limit "non-mission related assets" of all three entities. There are separate provisions for both the Federal Home Loan Banks and Fannie Mae/Freddie Mac.

Comments: *This provision derails regulatory efforts underway at both the FHFB and at HUD. Both agencies are studying whether and how investments by the three entities should be regulated. Neither agency has come to a concrete position, due to the complex issues associated with such regulation. All of this information gathering would be repudiated and regulation required without any further study. This may turn out to be needless regulation.*

There is no definition of the term "nonmission related asset." In addition, the way the provision is drafted suggests that the Board could define the term "nonmission-related asset" differently for Fannie Mae/Freddie Mac than for the Federal Home Loan Banks. This is another example of defeating the purpose of consolidating regulators and the possibilities embedded in the bill to treat some entities more favorably than others -- with no limits on that discretion.

Section 112. Conforming Loan Limits.

This section changes the loan limit provisions in the current Fannie Mae and Freddie Mac charters to reflect the most recent loan limit of $252,700. The provision retains current practice for setting loan limits, except that the Board is directed to develop a "successor" to the FHFB house price index currently used to determine the loan limits and include within that successor index the OFHEO house price index.

Comments: *This provision does not adequately define "house price index." Combining the FHFB and OFHEO house price indices would be confusing and may not be possible. In any event, the Board is free to develop its own house price index as a "successor" that need not follow any of the established economics used by the FHFB or OFHEO. This could result in a long, new regulatory process and could negatively affect the ability of the entities to offer products as prices increase.*

Section 113. Definitions.

Technical.

Section 114. Supervision of Federal Home Loan Bank System.

Technical.

Section 115. Amendments to Title 5, United States Code.

Technical.

Subtitle B—Reduction of Systemic Risk

Section 131. Annual Review of Enterprises by Rating Organizations.

This section requires a yearly assessment of the financial condition of Fannie Mae, Freddie Mac and each of the Federal Home Loan Banks by two nationally recognized rating agencies, including the ability to repay obligations. In addition, the assessment must include a credit rating. The bill requires the three entities to pay for these credit assessments.

Comments: Fannie Mae endorses efficient mechanisms of providing information to investors and to the markets and thus provides a great deal of information to analysts and investors. In addition, our safety and soundness regulator examines us regularly and provides the results of those examinations to the public. The ratings agencies already assess the relative risk of our fixed income obligations and rate Fannie Mae at AAA. Thus, the system already has transparency. The ratings requirements of this section would add little additional information to what is currently available. Strong incentives to communicate information to the equity and bond markets about our risk profile and business prospects already exist. Equity and bond investors spend a tremendous amount of time and effort in analyzing and understanding Fannie Mae's business. In addition, annual "risk to the government" ratings could politicize the ratings process. At least one of the major rating agencies appears to concur. When asked in 1996 to provide a hypothetical rating for Fannie Mae that would rate the "risk to the government," Moody's declined to do so on the grounds that their ratings are designed to provide guidance to investors and should not be the basis for policy action.

Section 132. Annual Reports.

This section extends the reporting requirements of Fannie Mae and Freddie Mac to the Federal Home Loan Banks.

Section 133. Risk-Based Capital Test for Enterprises.

This section makes changes to the current statutory requirements for OFHEO to establish a risk-based capital test for Fannie Mae and Freddie Mac. It grants authority to the Board to consider, in its sole discretion, any appropriate methods of measuring credit risk and allows the Board to consider anything it deems appropriate in establishing the risk-based capital test. The Board is given discretion to increase the existing 30 percent add-on for management and operations risk.

Comments: This provision grants very broad and standardless authority to the Board in setting the risk-based capital standards for Fannie Mae and Freddie Mac. This provision thus overrides an already complex statutory attempt to outline a stress test for the two companies. OFHEO has received extensive comment on the way it has interpreted the existing statutory provisions. Under this broad new discretion, the Board could set any standard it wants, without any input from the public. Giving an entity "sole discretion" to determine complex economic scenarios is unprecedented. The current 30 percent management and operations add on is more than sufficient and is already in addition to the amount of capital required under the stress test. The Board would have the ability to increase the capital requirements of Fannie Mae and Freddie Mac on the basis of this provision beyond any standard that is economically reasonable.

This provision is not extended to the Federal Home Loan Banks, raising the issue of uneven and discriminatory regulatory treatment. The Board will have to propose two different risk-based capital regulations. The current capital approach proposed by the FHFB is dramatically different from and less stringent than the OFHEO proposal.

In addition, the provision as drafted does not make it clear whether the current OFHEO regulatory process will go forward or the Board will start from scratch in devising a risk-based capital standard for Fannie Mae and Freddie Mac-- a process that has already taken 8 years.

Section 134. Effective Date for Supervisory Actions.

This section allows the Board to take supervisory actions 6 months after the effective date of the

risk-based capital regulations, rather than 1 year after the effective date.

Section 135. Appointment of Receivers.

This section authorizes the Board to appoint a receiver instead of a conservator for a GSE that is critically undercapitalized. The Board is given complete discretion to adopt a regulation that will set the standards that must be triggered for appointment of a receiver. The Board must notify Congress if it appoints a receiver. This provision also gives the Board authority to establish regulations under which a receiver may liquidate or "wind up" the affairs of the GSEs.

Comments: This provision reverses the decision of Congress in 1992 that a troubled enterprise should be placed in conservatorship until financial problems are solved rather than granting a government agency authority to liquidate and terminate the existence of Fannie Mae and Freddie Mac in receivership. The Board is given limitless discretion to determine how the affairs of these companies should be terminated. It is unclear whether this provision is sufficient to terminate the existence of Fannie Mae and Freddie Mac -- companies chartered by Congress. It may be that a specific Act of Congress would be needed to terminate the companies.

Section 136. Repeal of Treasury Lines of Credit.

The bill repeals the Treasury lines of credit for Fannie Mae, Freddie Mac ($2.25 billion each) and the FHLBanks ($4 billion).

Comments: Testimony on this provision of the bill resulted in significant shifts in the agency debt markets.

Section 137. Board Membership on FFIEC.

The Board is made a member of the FFIEC.

Comments: This provision is inconsistent with the different regulatory schemes for banks/thrifts and the GSEs. It is unclear whether the Board's regulations would have to go through the FFIEC process and how the Board would participate in FFIEC decisions. Would the FFIEC have a role in regulation of the GSEs? Similarly it is unclear whether the Board would have a role in determining the direction of bank/thrift regulation.

Section 138. Elimination of Super-Lien for Federal Home Loan Banks.

This provision eliminates the priority given a Federal Home Loan Bank's security interest in the assets of a member financial institution that fails.

Section 139. Federal Home Loan Bank Finance Corporation.

The bill establishes a Finance Corporation for the Federal Home Loan Banks to issue and service the debt obligations of the Banks. The Finance Corporation is a federally chartered instrumentality.

Section 140. Capital Treatment of Private Label MBS.

The bill contains a sense of the Congress resolution endorsing the proposed rules issued by the banking regulators that would put the risk-based capital treatment for AAA private-label MBS on the same footing with those of Fannie Mae and Freddie Mac.

Comments: This extraordinary provision actually endorses a rule that is going through the OMB process for rulemakings in accordance with the APA. The basis for this endorsement is unclear and therefore vague.

Section 141. Study of Effects of GSE Failure on Depository Institutions.

The FDIC, in consultation with the Federal Reserve, is required to study the existing exposure of depository institutions to default or failure of each of the GSEs.

*Comments: The bill requires FDIC and the Fed to study the effect on FDIC-insured institutions of a failure by a GSE to meet its capital requirements or if a GSE **defaults** on its obligations. Such a study would have too narrow a focus.*

WRITTEN STATEMENT OF LELAND C. BRENDSEL

CHAIRMAN AND CHIEF EXECUTIVE OFFICER

FREDDIE MAC

BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS,

SECURITIES

AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON BANKING AND FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

MAY 16, 2000

Good morning Chairman Baker, Congressman Kanjorski and Members of the Subcommittee. It is a pleasure to be here. I am Leland C. Brendsel, Chairman and Chief Executive Officer of the Federal Home Loan Mortgage Corporation, known as Freddie Mac.

I want to thank you for the opportunity to discuss Freddie Mac, our vital role in the nation's mortgage finance system, our commitment to making the American dream of decent, accessible housing a reality and our views on H.R. 3703, the "Housing Finance Regulatory Improvement Act," introduced by Chairman Baker.

Since our beginning in 1970, Freddie Mac has purchased more than $2 trillion in residential mortgages, financing homes for more than 25 million families. Because of the high level of support provided by Freddie Mac and the secondary market, America enjoys the world's best housing finance system. Mortgage rates are lower, saving homeowners thousands of dollars in interest payments. Low-downpayment loans are more readily available, enabling people to purchase their first homes. Families can count on the availability of mortgage credit whenever and where ever they need it.

In fact, our nation's mortgage finance system works so well that most Americans take for granted a reliable supply of low-cost mortgage credit in communities across the nation, every day.

This was not always the case. The development of America's mortgage finance system, with Freddie Mac as a private company created to serve a public purpose, is a tremendous Congressional success story.[1] This system ensures that America's future generations continue to receive its many benefits.

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[1] As the Senate Committee on Banking, Housing and Urban Affairs observed in 1992: "Congress created [Freddie Mac] under private ownership and management to bring the entrepreneurial skills of the private sector to bear on the accomplishments of public purposes relating to housing." Senate Report No. 282. 102nd Cong. 2nd Sess at 25 (1992).

Freddie Mac appreciates your efforts to assess whether the regulatory structure established in the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the 1992 Act) is working effectively and efficiently to ensure that we are operating safely and soundly and fulfilling our public mission. Freddie Mac shares Chairman Baker's desire to ensure a strong, independent and effective safety and soundness regulatory structure. However, we believe the proposed bill in its current form would not accomplish this objective. America's housing finance system works incredibly well, and changes to it run the risk of reducing the availability and affordability of mortgage credit for America's families and threatening the stability of the $5 trillion residential mortgage market.

Freddie Mac brings significant benefits to the mortgage market, including: lower mortgage costs; greater stability; increased innovation; and expanded housing opportunities. We bring these benefits at no cost to the government.

Before commenting specifically on H.R. 3703, I would like to provide an overview of Freddie Mac and our operations in the global capital markets, review the benefits we bring to lenders and consumers, and dispel, once and for all, some myths that have emerged about Freddie Mac and how we meet our mission.

I. FREDDIE MAC'S OPERATIONS IN THE CAPITAL MARKETS

Freddie Mac was created by Congress in 1970 to establish and maintain a national secondary market for conventional residential mortgages. In our charter, Congress articulates four purposes for Freddie Mac:

- Provide stability in the secondary market for residential mortgages
- Respond appropriately to the private capital market
- Provide ongoing assistance to the secondary market for residential mortgages (including mortgages on housing for low- and moderate-income families)
- Promote access to mortgage credit throughout the nation (including central cities, rural areas, and other underserved areas)

Congress further specified that Freddie Mac accomplish the latter two purposes by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing.[2]

Freddie Mac fulfills these purposes every day by purchasing mortgages from our nationwide network of lenders, overseeing the servicing of nine million loans, providing tools to keep mortgage lenders at the forefront of a changing market, issuing debt and mortgage-backed securities to meet investor needs, managing our retained mortgage portfolio, and maintaining sufficient capital to meet existing and future market needs. Through superb execution of these functions, we bring stability and liquidity to the housing finance system. This ensures that mortgages are continually available at lower cost to an increasing number of America's families, of all incomes, in all neighborhoods.

Freddie Mac is a secondary market company. We do not make mortgage loans. Instead, we provide our benefits to the mortgage market and America's families by purchasing loans originated by primary market lenders. We finance these loans in two ways: securitization and debt.

Securitization Financing. Under this method of financing, we purchase mortgages and package them into guaranteed mortgage passthrough securities, called Mortgage Participation Certificates, or PCs. We sell these mortgage securities through security dealers to investors in the capital markets.

Debt Financing. Under this method of financing, we purchase mortgages and mortgage-related securities for our retained portfolio and finance them with a variety of debt securities. We sell these debt securities through security dealers to investors in the capital markets.

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[2] 12 U.S.C. § 1451.

Freddie Mac's mission requires us to provide a continuous supply of mortgage credit for U.S. homebuyers in all economic environments. Freddie Mac flexibly employs both mortgage security and debt financing on a daily basis to accomplish this. We pioneered the development of the markets for mortgage-backed and debt securities that expand the investor base for America's housing. By using both of these financing methods, Freddie Mac assures mortgage lenders and America's families a stable supply of mortgage money at the lowest rates the capital markets have to offer.

Debt, in particular, has enabled Freddie Mac to expand the investor base for America's housing worldwide. A fixed payment schedule attracts international investors, bringing greater stability and liquidity to the U.S. mortgage market and making housing more affordable for the nation's families.

Freddie Mac's participation in the U.S. mortgage market and global securities market serves to link America's homebuyers with the world's capital markets. Fulfilling this role requires Freddie Mac to meet the challenge of improving access to low-cost mortgage financing while maintaining the financial strength that attracts capital to housing.

Freddie Mac's business is financing the high-quality mortgages backed by the equity in people's homes. Our mortgage risk management is second to none. Moreover, we hold sufficient capital to withstand extreme changes in both interest rates and credit conditions. As a result, Freddie Mac is among the strongest financial institutions.

II. KEY BENEFITS PROVIDED BY FREDDIE MAC

BENEFIT: Freddie Mac Lowers Mortgage Interest Rates for Borrowers

Freddie Mac and the secondary market lower mortgage rates and make housing more affordable. As the 1996 studies by the General Accounting Office, HUD, Treasury and the Congressional Budget Office each concluded, interest rates on mortgages that Freddie Mac can buy are lower than on other mortgages. An independent study commissioned by the four governmental organizations found that conforming fixed-rate mortgage rates

(i.e., rates on mortgages of a size eligible for purchase by Freddie Mac, currently those up to $252,700 for one-unit properties) are approximately 25 to 40 basis points, or more, lower than rates on loans exceeding the conforming loan limit.[3]

You don't have to rely on these estimates, just look at the mortgage rates reported weekly in *The Wall Street Journal*. On May 5, 2000, for example, rates on jumbo mortgages were 30 basis points higher than rates on the mortgages Freddie Mac can buy.[4]

As a result of the lower mortgage rates Freddie Mac and the secondary market provide, homeowners save approximately $12,000 in mortgage interest on a 30-year mortgage. Collectively, every year America's homeowners save $15 billion in mortgage interest payments.

Freddie Mac and the secondary market also ensure that mortgage credit is available at virtually the same mortgage rates nationwide. Because we support a national market, mortgage funds flow freely to communities across the country to meet the needs of the nation's homebuyers.

By attracting investors for long-term securities worldwide, Freddie Mac makes fixed-rate mortgages more available. As a result, when interest rates rise, mortgage borrowers are protected from higher costs.

What might we expect if Freddie Mac and Fannie Mae were no longer looked to as pillars of the housing finance system? One only need examine the segments of the U.S. mortgage market we do not serve, the mortgage markets in other countries[5] or the U.S.

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[3] Cotterman, Robert F. and James E. Pearce, "The Effects of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation on Conventional Fixed-Rate Mortgage Yields," in *Studies on Privatizing Fannie Mae and Freddie Mac*, ed. by U.S. Department of Housing and Urban Development, 97-168 (1996).

[4] *The Wall Street Journal*, W14.

[5] The most common mortgage: in the United Kingdom has a 20 percent downpayment and the interest-rate adjusts at the lender's discretion; in France requires a 30 to 40 percent downpayment on a fixed-rate

market before Freddie Mac was created. Mortgage rates, downpayments and the use of adjustable-rate mortgages would all be higher, which would increase the cost of housing for America's families, reduce homeownership and put borrowers at greater risk of foreclosure.

BENEFIT: Freddie Mac Brings Proven Stability to the Nation's Mortgage Markets

Freddie Mac and the secondary market provide a reliable flow of mortgage credit, supporting the nation's housing finance system in good times and bad. Despite extraordinary upheavals in the mortgage and real estate industries during the past decade, America's families enjoyed an uninterrupted flow of mortgage credit.

- During the savings and loan crisis from 1986 to 1989, when the nation's primary source of mortgage credit was failing, Freddie Mac provided more than $300 billion to meet the credit needs of America's families.

- When commercial banks tightened lending standards in the early 1990s as a result of commercial real estate losses, the nation's small businesses experienced a "credit crunch" but housing credit remained readily available. Freddie Mac provided nearly $370 billion to finance housing during that period.

- When interest rates fell in 1993 and 1994, homeowners in record numbers wanted to refinance their homes, and Freddie Mac provided more than $350 billion in mortgage credit.

- During the fall of 1998, worldwide turmoil in the financial markets led to a liquidity crunch in several domestic market sectors, including commercial and subprime residential mortgages, as investors fled many investments and poured funds into U.S. Treasury bonds. Because demand for Freddie Mac's debt

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mortgage: and in Japan has a subsidized mortgage interest rate but requires a downpayment of 40 percent or more. Ellen Roche, "Loans Around the World," *Secondary Mortgage Markets*, April 1997.

securities remained high, Freddie Mac was able to keep funds flowing into the residential mortgage market.

Our ability to issue both mortgage-backed securities and debt to finance mortgage purchases is essential to the smooth functioning and stability of the housing finance system. A study by Capital Economics stated that our debt-funded purchases "stabilized home loan rates during the credit crunch of 1998. For consumers in the home loan market during the financial crisis of 1998, mortgage credit remained available *and* affordable."[6]

BENEFIT: Freddie Mac Pioneers Innovation in Housing Finance

Throughout our history, Freddie Mac has been a pioneer in innovation, exploring new frontiers that create a faster, more efficient and less costly mortgage finance system. Our innovation in financial instruments attracts more investors to finance America's housing, which ensures mortgage money is available at lower cost for homebuyers. We also innovate to streamline the mortgage process, which reduces the time and up-front costs of getting a mortgage.

Following are examples of the many milestones in the development of the mortgage market that can be traced to Freddie Mac.

- In 1971, Freddie Mac issued a passthrough security backed by conventional mortgages, developing the market for securities that expand the investor base for housing.
- In 1973, Freddie Mac joined with Fannie Mae in standardizing mortgage loan applications and single-family appraisal forms.

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6 "An Economic Analysis of Freddie Mac's (and Fannie Mae's) Contribution to Liquidity in the Residential Mortgage-Backed Securities Market During the Credit Crunch of 1998," Capital Economics, May 2000 (emphasis in original).

- In 1983, Freddie Mac issued the first multiclass mortgage security, the forerunner to today's Real Estate Mortgage Investment Conduit (REMIC).

- In 1984, Freddie Mac facilitated the first paperless, computer-to-computer delivery of mortgages to the secondary market.

- In 1985, Freddie Mac's mortgage-backed securities began trading electronically in the book-entry system rather than in paper form.

- In 1995, Freddie Mac introduced automated underwriting to the market with Loan Prospector®.

- In 1999, Freddie Mac introduced Loan Prospector on the Internet.

- In 1999, Freddie Mac launched the first corporate debt financing calendar.

All of these innovations deliver benefits to America's families. Freddie Mac operates in the U.S. mortgage markets and the global capital markets, and as the examples above demonstrate, we have brought innovation to both.

The markets we have developed for mortgage-backed and debt securities have attracted a global investor base to finance America's housing. This was not always the case. In 1970, residential mortgage debt outstanding totaled about $0.4 trillion, most of which was held by thrifts. Now more than $5 trillion in mortgages and mortgage-backed securities are held by a diverse investor base worldwide. The single- and multiclass mortgage security markets we developed in the 1970s and 1980s significantly increased the share of mortgage debt held by pension funds, insurance companies and commercial banks. More recently, Freddie Mac's innovations in the debt markets have attracted an international investor base. This increases the global demand and liquidity of our securities, which enables us to reduce costs for homebuyers and renters.

For 30 years, Freddie Mac also has lead the way in streamlining the mortgage process, reducing the time and cost to get a mortgage loan. Freddie Mac's automated

underwriting service, Loan Prospector, has fundamentally transformed the way mortgages are originated. With Loan Prospector, approving mortgages is easier and faster, costs are lower and the application of objective underwriting criteria is more consistent. Additionally, by more accurately measuring risk, Loan Prospector extends the benefits of the mortgage finance system to more borrowers.

Freddie Mac uses technology, such as automated underwriting, to make the mortgage finance system more objective and fair. We also take specific, additional steps to ensure that our automated underwriting technologies and other recommended statistical tools are used in a way that promote access to credit and fairness in the mortgage process.

To further distribute the benefits of faster, more accurate approvals and lower costs throughout the mortgage market, Freddie Mac introduced an Internet version of Loan Prospector in July 1999. Loan Prospector on the Internet (LPI) is a web-based version of Freddie Mac's automated underwriting service that delivers a Freddie Mac purchase decision within minutes at the point of sale. LPI permits lenders to compete in the age of electronic commerce by bringing the benefits of Loan Prospector to America's homebuyers as quickly, easily and efficiently as possible.

Automated underwriting services such as Loan Prospector can reduce origination costs by up to $650, and when combined with other online efficiencies, the potential savings from Internet-based automated underwriting services increase to $2,000. These services also can shorten the time to loan closing and allow approval of loans for borrowers with less traditional credit profiles and limited savings. Based upon U.S. Census Bureau estimates, a reduction of $1,000 in origination costs could help an additional 116,000 renters afford to become homeowners and a reduction of $2,000 in origination costs could make it possible for an additional 314,000 renters to afford a home.[7]

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[7] "Who Can Afford to Buy a House in 1995", by Howard Savage, U.S. Census Bureau, *Current Housing Reports H121/99-1*, August 1999, Table 5-3.

BENEFIT: Freddie Mac Expands Housing Opportunities

Freddie Mac serves families at all income levels, in all kinds of communities, in all parts of the country. In fact, Freddie Mac's purchases closely mirror the activities of the primary market in terms of the share of business from central cities, suburbs and rural areas, as well as by the distributions of borrower income and census tract income. Freddie Mac takes great pride in these accomplishments. At the same time, we are continuously improving our business activities to make homeownership attainable for even more families.

In 1999 alone, Freddie Mac purchased nearly $241 billion of single-family and multifamily mortgages, financing homes for 2.3 million families.[8] Nearly 1.3 million of these mortgages, representing more than 55 percent of our total purchases, funded housing for very-low-, low- or moderate-income families or families living in underserved areas.

Single-Family Housing (One to Four Units). Freddie Mac purchased $233 billion in single-family mortgages, financing homes for 2.1 million families. Our home-purchase financing included 178,000 first-time homebuyers, who accounted for 25 percent of the home purchase loans we bought in 1999. By financing approximately one in eight first-time homebuyer mortgages originated last year, Freddie Mac played a significant role in boosting the national homeownership rate to 67 percent. In addition, Freddie Mac's purchases in 1999 funded mortgages for more than 259,000 minority families.

Multifamily Housing (Five or More Units). Freddie Mac's multifamily mortgage financing in 1999 totaled $7.6 billion, financing rental housing for 191,000 families, and 90 percent of these units were affordable to low- and moderate-income families. In addition, with $244 million in investments in rental housing eligible for Low-Income Housing Tax Credits in 1999, our total investments surpassed $1 billion.

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[8] These numbers refer to purchases eligible for reporting to HUD for affordable housing goals. Freddie Mac's total 1999 purchases were $272 billion. "We Open Doors to America's Housing," Freddie Mac's Annual Affordable Housing Report for 1999, March 15, 2000.

Freddie Mac Achieved Our Affordable Housing Goals in 1999. As a result of our continued efforts to extend the reach of the mortgage market to low- and moderate-income families and those living in underserved areas, combined with favorable economic conditions, Freddie Mac met all three of the affordable housing goals established by HUD in 1999:

- The low- and moderate-income housing goal for 1999 was 42 percent of the total number of dwelling units financed by our mortgage purchases. During 1999, 46.4 percent of the units Freddie Mac financed were affordable to low- and moderate-income families. These purchases totaled $80 billion and financed housing for more than one million families.

- The underserved areas goal for 1999 was 24 percent of the total number of dwelling units financed. During 1999, 27.6 percent of the units Freddie Mac financed were located in underserved areas. These purchases totaled $51.8 billion and financed housing for 619,000 families.

- The special affordable housing goal for 1999 was 14 percent of the total number of dwelling units financed. During 1999, 17.3 percent of the units Freddie Mac financed were affordable to low-income families in low-income areas or to very-low-income families. These purchases totaled $22.5 billion and financed housing for 386,000 families. The multifamily housing target within the special affordable goal was $988 million. In 1999, $2.3 billion of Freddie Mac's purchases eligible for the special affordable goal were multifamily mortgages.

Serving Minority Families. Freddie Mac is an active and creative force in reducing costs and making mortgage money available for minority families. The benefits we bring to the housing finance system are making homeownership a reality for those who previously considered it out of reach. We are proud of our achievements in serving the diversity of America's families. From 1996 through 1999, our mortgage purchases financed homes

for 835,000 minority families, including 200,000 African-American and 307,000 Hispanic families.[9]

More remains to be done. While homeownership rates for minority families have increased to record levels during the past decade, overall homeownership rates for African Americans, Hispanic Americans, and Native Americans remain well below those for non-Hispanic whites. Freddie Mac is committed to increasing minority homeownership rates across the country.

In achieving this objective, we use a multifaceted approach that includes working with minority-owned lenders, creating targeted loan products, reaching out to minority-based organizations and designing homebuyer education that enables families to achieve and maintain good credit.

Our newest initiatives will help even more families achieve homeownership. Examples of our recent initiatives include:

- **Five-Year Alliance with the NAACP** -- In early 1999, Freddie Mac and the NAACP announced a new five-year alliance designed to increase minority homeownership. As part of the initiative, Freddie Mac has committed to purchase up to $500 million in mortgages originated by Bank of America and other participating lenders.

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[9] The share of Freddie Mac's purchases of loans serving minority families essentially mirrors the share of loans serving minority families originated in the primary market, when appropriately measured. Freddie Mac's performance in serving minority families is often evaluated using Home Mortgage Disclosure Act (HMDA) data. These comparisons create a misleading and inaccurate impression about Freddie Mac's service to minority borrowers – particularly African-American and Hispanic borrowers – for a number of reasons. First, HMDA data include manufactured housing and subprime loans that are not generally purchased by Freddie Mac, which have disproportionately high shares of African-American and Hispanic borrowers. In addition, HMDA data include low-downpayment loans without mortgage insurance, which Freddie Mac generally cannot buy. It is simply not accurate to compare our purchases with data that include these sectors of the primary market.

- **Consumer Credit Education:** Freddie Mac has launched a homebuyer and credit information initiative aimed at explaining the role that good credit plays in obtaining the most affordable mortgages in the market. Our series of credit education brochures, sponsored with each of these organizations – the NAACP, the Mortgage Bankers Association of America, the National Association of Real Estate Brokers and the National Association of Realtors – helps consumers understand the importance of good credit.

  Freddie Mac has also announced a joint, multi-year. multi-million dollar Consumer Credit Initiative with five of the nation's Historically Black Colleges and Universities (HBCUs) aimed at increasing minority homeownership rates by helping consumers better understand credit and develop and maintain solid credit records.

- **Freddie Mac/Wall Street Project Minority Homeownership Initiative**: In April 2000, Freddie Mac and the Rainbow PUSH Coalition/Wall Street Project entered into a joint campaign to increase homeownership among minority families. Freddie Mac committed $1 million to help leverage the infrastructure of the Wall Street Project's "One Thousand Churches Connected" economic literacy effort to provide information about the benefits of homeownership and the mechanics of the homebuying process, as well as about mortgage loan products available as part of the initiative. As part of the campaign. Freddie Mac has committed to purchase up to $1 billion in mortgage loans made to minority families by Bank of America and minority-owned lenders over the next five years.

Freddie Mac's Steps to Combat Predatory Lending. Subprime loans are an important option for borrowers with past credit problems, and not all subprime loans are predatory. At the same time, there are clear examples of abusive lending practices in this market segment. This is one reason Freddie Mac's participation in purchasing and securitizing higher-risk mortgages has been gradual and deliberate. We want to take the time to be

sure we promote responsible lending and enable families to build wealth through homeownership.

Based on our experience in the subprime market, Freddie Mac has taken vigorous steps to address predatory practices, and to begin establishing standards that can be used across the entire market.

- *HOEPA Loans* – Freddie Mac will not purchase high-rate or high-fee loans that are covered by the Home Ownership and Equity Protection Act of 1994 (HOEPA) and current implementing regulations published by the Board of Governors of the Federal Reserve System.[10]

- *Single-Premium Credit Insurance* – Freddie Mac will not purchase loans where single-premium credit life, property, disability or unemployment insurance is financed out of the loan proceeds.

- *Credit Reporting* – Freddie Mac requires lenders we do business with to report monthly borrower mortgage payments to all three major credit repositories so that borrowers with good payment records can obtain lower-cost loans when their credit improves.

- *Good Business Practices* – Freddie Mac monitors the practices of lenders we do business with, and we have refused to do business with some of the largest lenders in the subprime market segment due to concerns with their lending practices.

- *Servicing Tools* – Freddie Mac provides loan servicers with tools that enable them to identify homeowners most at risk of foreclosure and work with them to reduce foreclosures and to avoid late fees that can drain equity.

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[10] 12 C.F.R. §226.32 (1999).

Freddie Mac is also bringing benefits to the subprime segment of the market by providing a wider range of mortgage products which make credit less costly and more sustainable for borrowers. We are continually introducing innovative new loan products aimed at giving borrowers with impaired credit greater mortgage product choices. Some of our recent products and initiatives include:

- CreditWorks℠ – This is a $100 million initiative in which we purchase a market rate mortgage for borrowers who successfully participate in a debt management counseling program with a nonprofit counseling service. These borrowers otherwise would likely pay higher rates in the subprime market.

- Affordable MeritRate Mortgage℠ – Our new mortgage product for borrowers with impaired credit in which the borrower's interest rate is reduced after two years of timely payments.

- Lease-purchases – Working together with state and local housing authorities, our lease-purchase initiative allows borrowers to use rental payments toward purchase of a home.

The steps we are taking to promote responsible lending and the new mortgage products and initiatives we are bringing to the subprime segment of the conventional mortgage market promise to bring standardization, increased competition, a broader variety of mortgage products and lower costs. These actions protect borrowers who are vulnerable to abusive lending practices. We have been commended for the steps we are taking by legislators, consumer advocates and the mortgage industry.[11]

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11 "Freddie Mac's announcement today puts the subprime lending industry on notice that there is no secondary market for predatory loans. By saying 'no' to loans with single-premium credit insurance, 'yes' to timely payment reporting, and by monitoring lender practices, Freddie Mac will further help homeowners build wealth for themselves and their families, and not unscrupulous lenders." Statement of Rep. David E. Price; "I am pleased that Freddie Mac is taking these steps, which will help reduce abusive

Freddie Mac opens doors to housing in many ways, and we are constantly seeking new ways to bring the benefits of home financing to a broader array of America's families.

Freddie Mac Provides These Benefits at No Cost to the Government

Because Freddie Mac was established by Congress to harness the private sector to fulfill a public purpose, Freddie Mac benefits America's homebuyers and renters at no cost to the government. We receive no appropriated funds. We receive no federal loans. Our securities are not guaranteed by the government. Indeed, Freddie Mac is one of the country's largest federal taxpayers. Freddie Mac has paid approximately $3 billion in federal income taxes over the past five years.

III. SETTING THE RECORD STRAIGHT

In discussions about Freddie Mac, our role in the housing finance system and the effectiveness of our regulatory structure, a number of myths about Freddie Mac have emerged. I would like to take the opportunity today to set the record straight.

MYTH: Freddie Mac Is the Next Thrift Crisis Waiting to Happen

REALITY: Freddie Mac Is Among the Strongest Financial Institutions

Freddie Mac's assets are the high-quality mortgages backed by equity in people's homes. The tools we have developed to manage both credit and interest-rate risk are second to none. We pioneered the development of automated tools that enable us to accurately

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and unfair home lending practices. Helping create an environment that discourages abusive practices that strip wealth and equity from homeowners who can least afford it will help strengthen neighborhoods throughout our country." Statement of Sen. Paul Sarbanes, the Ranking Democrat on the Senate Banking, Housing and Urban Affairs Committee, March 24, 2000; "The bottom line is that Freddie Mac is committing to bring responsible lending to the most vulnerable homeowners in the mortgage market. I especially commend Freddie Mac for its leadership stand on upfront credit insurance, one of the largest causes of home foreclosure in America today." Statement of Martin Eakes, President and CEO of the Self-Help Credit Union and national spokesperson for the Coalition for Responsible Lending, "Freddie Mac Announces Steps to Protect Borrowers from Predatory Lending Practices." March 24, 2000.

assess credit risk and help families avoid foreclosures. By funding mortgages nationwide, the geographic diversity of our mortgages mitigates the risk of local economic downturns. We are further protected through the use of third-party credit enhancements on a large share of our mortgage purchases. Freddie Mac's world class interest-rate management encompasses funding mortgages with a variety of mortgage securities, callable debt and other financial instruments that enable us to closely match the maturities of our assets and liabilities.

Not only is Freddie Mac highly skilled at managing risk, we are extremely well capitalized for the risks we take. Freddie Mac holds enough capital to withstand 10 years of severe, adverse economic conditions – much like the Great Depression. This is similar to the risk-based capital standard Congress established for Freddie Mac and Fannie Mae in the 1992 Act, which OFHEO is in the process of finalizing.[12]

In 1996, at OFHEO's request Standard and Poor's Corporation (S&P) rated Freddie Mac AA- on a stand-alone basis. Currently only six bank holding companies and no thrifts have ratings this high.

The difference between Freddie Mac and the thrifts could not be more stark. Thrifts in the 1980s were funding long-term mortgages with short-term deposits, and taking credit risk they could not manage.

Even today, the thrift industry has nowhere near the capital strength of Freddie Mac. Thrift capital requirements are based on a percentage of their assets. No matter how much risk a thrift takes, its capital standard remains the same. By contrast, the risk-based

[12] The 1992 Act requires Freddie Mac to meet a state-of-the-art risk-based capital standard that requires us to pass a stringent economic stress test. Under this test, Freddie Mac must hold sufficient capital to withstand a 10-year period during which credit losses equal, on a nationwide basis, the worst actual two-year regional experience. In addition, capital must be sufficient to survive interest-rate fluctuations of up to 600 basis points – greater interest-rate volatility than ever experienced by Freddie Mac in our 30-year history. Beyond this, Freddie Mac must hold capital of an additional 30 percent above the stress test level to absorb any possible management and operations risk.

capi'al standard for Freddie Mac and Fannie Mae is dynamic and depends on how well risk is managed.

In a 1999 study, thrift-industry expert IPS-Sendero applied OFHEO's capital standard for Freddie Mac and Fannie Mae to the thrift industry and found that it could not survive for five years of the 10-year stress test. The study concluded that the industry would need "more than three times their current capital level" to meet this capital standard.[13]

Recently, we asked former FDIC Chairman Bill Seidman to assess the relative stringency of this capital standard. He concluded that "the risk based capital standard set forth in the 1992 GSE Act creates a very stringent capital standard, one that could be devastatingly stringent if applied to most other financial institutions."[14]

The fact is, if the thrifts had held as much capital relative to risk as Freddie Mac does, there would never have been a thrift crisis.

Freddie Mac Has No Federal Guarantee: Thrift deposits are backed by the full faith and credit of the federal government. Freddie Mac has no such guarantee. Our charter explicitly states that Freddie Mac's securities are not guaranteed or otherwise backed by the full faith and credit of the United States. Furthermore, the documents offering every security we issue clearly state that investments in Freddie Mac instruments are not in any way backed by the government.

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13 "Thrift Industry Analysis: Implications of Risk-Based Capital Stress Test Requirements," IPS-Sendero, August 19, 1999.

14 L. William Seidman, Jacqueline Pace and David S. Chung, "Analysis of OFHEO Risk-Based Capital Standard," Memorandum to Freddie Mac, March 29, 2000.

MYTH: Freddie Mac Is Expanding Beyond the Charter

REALITY: All of our Activities Are Mission-Related

Over the past decade, Freddie Mac has played an integral part in reducing the time, cost and complexity involved in getting a mortgage – changes that directly benefit consumers and fulfill our public mission. As we consider the housing finance needs of the next generation of borrowers, the drive to innovate will only intensify. The dynamic nature of mortgage markets requires us to constantly improve the housing finance system to meet lender and borrower needs.

Some participants in the mortgage industry are threatened by these dramatic changes and react by attempting to impede market innovation, claiming that our activities go beyond our charter. What are we being criticized for?

- Using the latest technology to reduce the time and cost of getting a mortgage
- Responding to lenders who want to sell mortgages over the Internet
- Improving practices in the subprime sector

Each of these are about making mortgages more affordable, making the mortgage process easier for lenders and borrowers, and opening doors to homeownership. Each of these provides direct benefits to consumers and falls squarely within our charter and our public mission.

MYTH: Freddie Mac's Debt Is Growing Unnecessarily

REALITY: Our Debt Attracts Investors Worldwide to Finance America's Housing, Reducing Costs and Keeping Mortgage Credit Available

Much has been made of comparisons of the size of our debt with Treasury's. The truth is both Treasury debt declining and Freddie Mac debt increasing reflect positive developments for America's families. Mortgage debt has grown in response to the

increase in homeownership, and is backed by the safest form of collateral – the equity in people's homes.

America now has a record 67 percent homeownership rate. More than 70 million families own their own homes. As homeownership rates increase, so does the amount of mortgage money needed to finance those homes. This is illustrated by the fact that Freddie Mac's growth is consistent with the growth of the mortgage market.

Issuing debt is one of the tools we use to ensure the smooth functioning of the housing finance system and a key way we hold down the cost of financing homeownership.

Freddie Mac's mission requires us to provide a continuous supply of mortgage credit for U.S. homebuyers in all economic environments. To accomplish this has required us to accept this challenge: expand our investor base with financing that meets investors' varying needs while also managing our risk. To this end. Freddie Mac developed a combination of short-term debt, long-term callable and non-callable debt and other financial instruments that enable us to manage the interest-rate risk of debt-funded mortgages. By using both mortgage-backed securities and debt to finance our mortgage purchases. Freddie Mac is able to provide a stable supply of low-cost mortgage money.

Debt. in particular, has enabled Freddie Mac to expand the investor base for America's housing worldwide. International investors have little experience with long-term, fixed-rate mortgages. which are largely unavailable outside the U.S. They prefer the certainty of debt's fixed payment schedule. As a result, Freddie Mac's use of debt to fund mortgage purchases attracts additional investors and brings greater stability and liquidity to the U.S. mortgage market, making housing more affordable for the nation's families.

In the fall of 1998, for example, international capital markets were in turmoil. In many markets. credit was expensive and hard to get. Freddie Mac provided liquidity and stability to the mortgage market by purchasing mortgage securities for our debt-funded retained portfolio. As a result, there was no disruption to the mortgage market we serve. This was confirmed by the Capital Economics report referred to earlier, which concluded

that Freddie Mac and Fannie Mae stabilized residential mortgage rates during the international financial crisis of 1998 by providing liquidity to the secondary market for conforming home loans.

MYTH: Freddie Mac Dominates the Mortgage Market

REALITY: The U.S. Mortgage Market Is Highly Competitive

The United States enjoys the best mortgage finance system in the world. Every single day America's families are served by a system that works to make their housing dreams a reality. The housing finance system works so well that its infrastructure is virtually invisible to most consumers. Behind every mortgage is a highly competitive, intricate network that links together thousands of mortgage lenders, loan servicers, mortgage insurers and secondary market entities.

A wide range of lenders compete daily to originate mortgage loans in the primary market. Federally insured banks, savings and loan associations and credit unions and mortgage bankers, finance companies and other financial services companies compete to attract homeowners and homebuyers who want a mortgage loan. Private insurance companies compete with federal agencies such as the Federal Housing Administration (FHA) and the Department of Veterans Affairs (VA) to provide coverage for the risks attendant with certain mortgage loans. Secondary market entities, such as Freddie Mac and Fannie Mae, compete against each other as well as against Ginnie Mae, the Federal Home Loan Banks, federally insured depository institutions and other financial service providers to fund mortgage credit.

No single institution or group of institutions dominates the housing finance system. Fierce competition and changing market conditions work to create a dynamic and fluid system where the relative roles of the different participants can—and do—change dramatically from period to period.

The constantly changing and intensely competitive mortgage market environment in which Freddie Mac operates is reflected in dynamic changes in our market share. For example, in 1990, Freddie Mac's purchase share of total conventional single-family mortgage originations was 15 percent; this rose to 25 percent in 1993 as millions of homeowners refinanced their mortgages. By 1997, however, the refinance boom had passed, and Freddie Mac's share fell back to 15 percent. It is hardly the case that we dominate the market.

The truth is that because of Freddie Mac there is more competition in the industry than ever before. Thousands of lenders in the mortgage banking industry are able to compete to make mortgage loans to homebuyers because there is a secondary market able to fund those loans. The entry of new mortgage lenders using electronic commerce to expand homeownership opportunities demonstrates that the mortgage industry is still highly attractive and competitive.

IV. COMMENTS ON H.R. 3703

Let me now turn to the specifics of H.R. 3703, the Housing Finance Regulatory Improvement Act, which would amend the regulatory framework Congress created for Freddie Mac and Fannie Mae in 1992. As I stated at the outset of my testimony, Freddie Mac shares Chairman Baker's desire for a strong, independent and effective safety and soundness regulation for Freddie Mac. We believe, however, that the best means of ensuring this outcome is to let OFHEO complete its risk-based capital regulation. We have concluded that a number of the provisions in the bill would delay implementation of risk-based capital, stifle innovation and increase costs for homebuyers and renters.

Proposal to Consolidate Regulatory Oversight

H.R. 3703 would reorganize the regulatory oversight of Freddie Mac and Fannie Mae, creating a single regulator with both safety and soundness and mission oversight duties. The bill also would confer on this same regulator responsibility for overseeing the

Federal Home Loan Bank System. We have several concerns about whether this consolidation proposal would enhance our regulatory structure.

First, this is not the right time to consider fundamental changes in regulatory oversight. With respect to safety and soundness, the highest priority should be the implementation of risk-based capital regulations. OFHEO is close to finalizing regulations that will be the toughest, most sophisticated capital regulations in the financial services industry. Congress should permit OFHEO to complete this work. H.R. 3703 could delay the implementation of final risk-based capital regulations just as OFHEO is finalizing its regulations. Moreover, implementation of a final risk-based capital rule will give Freddie Mac clarity regarding the amount of capital that should be held relative to certain business activities.

Second, by combining regulatory oversight of Freddie Mac and Fannie Mae, on the one hand, and the Federal Home Loan Bank System, on the other, the bill would not achieve the legislative intent of regulatory efficiency, effectively requiring the creation of two, separate regulatory regimes housed under one roof. The Federal Home Loan Bank system has entirely distinct statutory authorities and purposes; entirely distinct capital standards and profiles; entirely distinct risk management profiles and capabilities; and distinct approaches to the use and volume of non-mortgage investments. As a result, consolidation would not provide the benefit of regulatory efficiencies and could compromise focus on Freddie Mac's and Fannie Mae's safety and soundness.

Proposals Regarding Regulatory Controls on Business Activities

The bill also would rewrite the existing regulatory requirements relating to Freddie Mac's business activities. These provisions depart significantly from the regulatory framework established in 1992. The 1992 Act requires strong regulatory oversight yet ensures that the regulator does not stifle innovation by needlessly intruding on Freddie Mac's secondary market operations. Our ability to respond appropriately and effectively to rapid developments in the mortgage and capital markets is essential to our success in

lowering the cost of mortgage credit for millions of families. Thus, Freddie Mac believes that, so long as we are adequately capitalized and our business initiatives are statutorily authorized and further our public purposes, regulatory intrusion in our business should be limited.

Burdensome Review of New Activities. H.R. 3703 contains a provision that would revise the process that Congress established in 1992 for regulatory review of new mortgage purchase programs. Freddie Mac believes the existing process provides for appropriate regulatory oversight while ensuring that unnecessary regulatory delay or micromanagement will not prevent Freddie Mac from responding to the ongoing needs of the mortgage and capital markets.

H.R. 3703 would create a burdensome regulatory oversight process that would impose significant costs and delays on new activities. The provision is flawed in many respects. Among other things, it would broaden the scope of review to encompass virtually every activity and business process that we undertake. Moreover, Freddie Mac would be obligated to await public comment and hearings before implementing any business plans. The result would be the stifling of innovation in the mortgage marketplace and the impeding of our ability to respond to the market. Last, this provision would be totally inconsistent with the direction of other financial services legislation and regulation that have sought to minimize unnecessary regulation and intrusion on business activities.

Unnecessary Regulation of Non-Mortgage Assets. H.R. 3703 also would require promulgation of new regulations governing Freddie Mac's non-mortgage assets. However, both of our oversight regulators already are authorized to act in this area and already are exercising that authority. Every non-mortgage investment Freddie Mac makes directly assists us in fulfilling our statutory purpose. These investments constitute a small but essential part of how we meet our mission. They are highly liquid and high quality. We hold these investments to manage the billions of dollars in cash flows we handle every month and to provide a diverse source of liquidity to ensure that we can purchase mortgages under a wide variety of financial conditions.

Both HUD and OFHEO already possess the authority under current law to oversee our investment activities effectively. HUD has required us to submit information on these investments for purposes of conducting mission oversight. OFHEO examines our investment activities as part of its safety and soundness oversight responsibilities and has concluded that our activities are safe and sound. Because HUD and OFHEO are appropriately exercising their existing authority in this area, additional regulation is not necessary.

Proposal to Repeal the Treasury's Securities Purchase Authority

I'd like to address the recommendation to repeal the Treasury's authority to purchase $2.25 billion of Freddie Mac and Fannie Mae securities. This provision would repeal a critical component of the framework that Congress established to support homeownership.

As you know, in March 2000, the Under Secretary of the Treasury testified in support of repeal of this provision as "consistent with the Congressional requirement that all GSE securities carry a disclaimer that they are not backed by the U.S. government."[15] This statement resulted in serious disruption in the mortgage-backed securities and debt markets. These events demonstrate the importance of careful consideration of the consequences of any real or perceived change in a well-established policy, since these types of proposals can unintentionally damage the housing finance system and increase the cost of homeownership.

First, it is important to understand what the Treasury's authority is and is not. This authority is often mistakenly referred to as a "line of credit." In fact, it merely authorizes Treasury to purchase up to $2.25 billion of our obligations – solely at the Treasury's option – to provide liquidity to the mortgage markets. Treasury has never exercised this authority. Given the rigor of our safety and soundness controls and the strength of our

capital base, it is extremely unlikely that the Treasury ever would need to consider exercising this discretionary purchase authority.

However, we believe Treasury's purchase authority has important value. An examination of the legislative history shows that Congress, in adopting the provision, intended to signify that homeownership is a national priority and that Freddie Mac's accomplishments in providing low-cost mortgage money to the housing finance system enjoys the support of Congress. Furthermore, the purchase authority is one component of an intricate and longstanding framework that has allowed for the development of the best mortgage finance system in the world. In repealing this provision, Congress runs the risk of uprooting the overall framework and thereby increasing costs to homebuyers. We, therefore, cannot support repeal of the Treasury's discretionary purchase authority.

Other Proposals

Financial Disclosure. Freddie Mac believes that our financial disclosures regarding the risk of our business activities, including our management of interest-rate risks, are among the most transparent in the financial services industry. Section 103 of H.R. 3703 would authorize the regulator to issue regulations to make public information that it determines would increase the efficiency of the secondary mortgage market. We find the new financial disclosure requirements problematic and agree with Under Secretary Gensler, who recognized in his testimony that this provision fails to recognize that some data are proprietary and would not be appropriate for public disclosure.[16]

Fundamentally, we do not believe that the sweeping regulations required by H.R. 3703 are necessary because Freddie Mac already takes extraordinary steps to ensure that investors and market participants have all the information necessary to evaluate our business practices and results. Freddie Mac publishes substantial and extensive

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[15] Treasury Under Secretary Gary Gensler, House Banking Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises, March 22, 2000.

[16] Ibid.

information that is comparable to what would be required for an SEC-registered company.

We recently retained PricewaterhouseCoopers to independently compare the completeness and transparency of our risk management disclosures to a group of large financial institutions whose financial disclosures are considered "best in class," or "best practices." PricewaterhouseCoopers found Freddie Mac's periodic risk management disclosures to be among the best of the disclosures made by this exemplary group.

Rating Agency Reviews. The bill also would require annual reviews and a credit rating by two rating agencies that would be included in an annual report to Congress. We support a role for rating agencies in the regulatory process, since they can provide valuable supplementary information for the regulator to consider in their assessment of the safety and soundness of an enterprise. In fact, the 1992 Act already allows OFHEO to obtain these ratings. We do have some concerns, however, regarding whether it is appropriate to make public the rating.

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Thank you for the opportunity to appear today. Freddie Mac is a great Congressional success story. We look forward to working with Chairman Baker, Representative Kanjorski and Members of this Subcommittee to ensure that the Congress has confidence that Freddie Mac is meeting our very important mission in a safe and sound manner. We are committed to making the world's best housing finance system even better for future generations of America's families.

MEMORANDUM

TO: Freddie Mac

FROM: L. William Seidman
Jacqueline Pace
David S. Chung

DATE: March 29, 2000

RE: Analysis of OFHEO Risk-Based Capital Standard

You have asked us to answer the following questions:

1. Whether the risk-based capital standard set forth in the 1992 GSE Act is an appropriate means of determining the capital adequacy of Freddie Mac and Fannie Mae (the Enterprises).

2. Whether a simple ratio-based approach alone would be appropriate for determining the capital adequacy of Freddie Mac and Fannie Mae.

3. Whether the risk-based capital standard set forth in the 1992 GSE Act is more stringent than any other regulatory capital standard that applies to a financial institution.

In arriving at our opinion, we have reviewed the following:

A. The Federal Reserve Letter on Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles (hereinafter "The Fed Letter").

B. The revised Uniform Financial Institutions Rating System (UFIRS) or CAMELS rating system that was issued recently by the Task Force on Supervision of the Federal Financial Institutions Examination Council (hereinafter "Revised CAMELS Rating System").

C. The Basle Accord's impact on Capital Requirements and Bank Behavior.

D. "Thrift Industry Analysis," the Sendero Corporation (1996).[1]

Based on this review, it is our opinion that:

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[1] *See also* Edward L. Golding and Carol A. Wambeke, *A Timely Look at Financial Soundness Measures, Secondary Mortgage Markets*, pp. 28-34 (July 1998).

The OFHEO risk based capital standard that relies on a 10-year stress test to determine capital requirements is an appropriate means of determining capital adequacy.

A simple ratio-based approach would NOT be appropriate for determining the capital adequacy of Freddie Mac and Fannie Mae. Simple ratios depend only on size and do not take into account how well risk is managed. Specifically, ratios are a rough and unsophisticated method of providing capital to absorb risk losses.

The risk based capital standard set forth in the 1992 GSE Act creates a very stringent capital standard, one that could be devastatingly stringent if applied to most other financial institutions.

The following analysis supports our view.

QUESTION 1: <u>AN ADEQUATE CAPITAL STANDARD</u>

The following sources support the proposition that a stress test designed to indicate required capital levels is considered the most appropriate means of assessing the Enterprises' stability. Moreover, they support the proposition that utilization of stress tests is considered the "best practice" around the world.

A. THE FED LETTER:

Recently the Federal Reserve issued a financial institution supervision letter (The Fed Letter) emphasizing the growing need for banking organizations to take greater efforts to assure that their capital adequacy is not only adequate to meet formal regulatory standards, but is also fully sufficient to support their underlying risk positions.

The Fed Letter suggests the following in regards to maintaining capital adequacy: identify and measure all material risk, relate capital to the level of risk and state explicit capital adequacy goals with respect to risk. To further each of these goals, the Federal Reserve suggests the use of a stress test and implementation of underlying principles similar to those expressed by OFHEO's proposed rule.

In order to deal with unquantifiable risks, the Federal Reserve suggests the use of more subjective, qualitative techniques. As for appropriately relating capital to the level of risk, the Federal Reserve suggests that the amount of capital held should reflect not only the measured amount of risk, but also an adequate "cushion" above that amount to take account of potential uncertainties in risk measurement. Specifically, the banking organization's capital should reflect the perceived level of precision in the risk measure used, the potential volatility of exposures, and the relative importance to the institution of the activities producing the risk. Capital levels should also reflect that historical correlations among exposures can rapidly change.

Many of these suggestions have been implemented by the risk-based capital standard

created by the 1992 Act. Specifically, the OFHEO stress test simulates how Freddie Mac and Fannie Mae would fare under severe economic conditions. Unlike a capital requirement based on a simple ratio of assets, OFHEO's stress test standard requires more capital for holding riskier assets, or more capital for failing to hedge them.

By using computer models to simulate Enterprise cash flows associated with mortgages and other financial assets and obligations under 10 years worth of severe economic conditions, OFHEO's stress test is equipped to keep problems under control as they crop up. The modeling of incoming and outgoing cash flows captures the risks embedded in those financial assets and obligations and the benefits of the hedges each Enterprise has set in place. Adhering to the Fed Letter's suggestions concerning the need for "customization," the OFHEO risk-based capital standard finds the worst mortgage default experience in any region in history, and applies it to the whole country. Within a year, rates are assumed to move up by 75% and remain. On top of these severe credit and interest rate shocks, Congress adds 30% more capital requirement. This additional capital corresponds to the "cushion," termed by the Fed Letter as an excellent means of covering other potential risks for large banking organizations (LCBOs).

According to Federal Reserve Chairman Alan Greenspan, "even among the largest banks, no two institutions have exactly the same risk profiles, risk controls, or organizational and management structure . . . accordingly, prudential policies need to be customized for each institution."

The OFHEO risk-based capital standard correctly allows for flexibility and does not prescribe any particular approach to capital compliance.[2] The standard directly captures the bottom line risk exposure of the Enterprises and takes into account all of their risk taking and risk management activities so that an Enterprise can meet the requirements by reducing risk, raising capital, or a combination of the two. The standard also takes into full account credit risk arising from securitization and other secondary market credit activities, including credit derivatives.[3]

Because previous capital standards treated most loans alike, institutions in the past, especially banks, had perverse incentives to reduce their regulatory capital requirements by securitizing or otherwise selling lower-risk assets, while increasing the average level of remaining credit risk through devices like first-loss positions and contingent exposure. To counter this incentive, it is important, therefore, that the Enterprises have the ability to assess their remaining risks and hold appropriate levels of capital and allowances for credit losses. These institutions, which are at the frontier of financial innovation, should also be at the frontier of risk measurement and internal capital allocation.

The OFHEO risk-based capital standard correctly recognizes operational risk and the wake of recent, highly visible breakdowns in internal controls and corporate governance by

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[2] The stress test approach can be flexible enough to address innovation. It can capture the risk of new products when they are introduced, and just as importantly, capture the reduction in risk from effective use of new financial instruments. This type of flexibility is critical to keeping the stress test from becoming obsolete.

[3] Maintaining detailed and comprehensive credit risk measures is most necessary at institutions that conduct asset securitization programs, due to the potential of these activities to greatly change – and reduce transparency of – the risk profile of credit portfolios.

internationally active institutions. Although operational risk does not easily lend itself to quantitative measurement, it can have substantial costs to banking organizations through error, fraud, or other performance problems. The great dependence of banking organizations on information technology systems highlights only one aspect of the growing need to identify and control this risk.

The OFHEO standard is consistent with the guidance for capital requirements set forth in the Fed Letter and will allow the Enterprises to demonstrate that their capital levels and composition are adequate to support the risks they face. The test takes appropriate account of the possibility that adverse events may have disproportionate effects on overall capital levels. Further, the test incorporates all of the principal credit and interest rate risks of the Enterprises and their interactions to produce a summary measure of risk. At the same time, the standard need not interfere with the Enterprise's choices about what activities to engage in or how to hedge their risks. They are free to pursue very different individual strategies. What the standard does is simply require that each Enterprise hold capital proportional to its overall risks which is the essence of the Fed Letter proposal.

THE REVISED CAMELS RATING SYSTEM –

On December 20, 1996, the FDIC Board of Directors adopted the Federal Financial Institutions Examination Council's (FFIEC) updated statement of policy entitled "Uniform Financial Institutions Rating System" (UFIRS). The updated UFIRS which replaced the 1979 statement of policy, provides a useful background in considering the soundness of the proposed regulation.

The UFIRS is an internal rating system used by federal and state regulators for assessing the soundness of financial institutions on a uniform basis and for identifying those institutions requiring special supervisory attention. Under the UFIRS, each financial institution is assigned a composite rating based on an evaluation and rating of five essential components of an institution's financial condition and operations. The five component areas were Capital adequacy, Asset quality, Management, Earnings, and Liquidity (CAMEL).

The CAMEL rating system was updated to become CAMELS by adding a sixth component called "Sensitivity to Market Risk" to emphasize risk assessment and the risk profile of the institution. By taking into account economic developments that may cause future problems, the CAMELS rating system, much like OFHEO's proposed rule, bridges the gap between the individual institution and the economic environment in which it operates.

For example, under the capital adequacy component[4] of the CAMELS rating system, a financial institution is expected to maintain capital commensurate with the nature and extent of risks to the institution and the ability of management to identify, measure, monitor, and control these risks. The similarities between the CAMELS standard and the OFHEO risk-based capital standard continue as both assess the effect of credit, market, and other risks on the institution's financial condition when evaluating the adequacy of capital. Both recognized that the types and

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quantity of risk inherent in an institution's activities will determine the extent to which it may be necessary to maintain capital above the required regulatory minimum ratios to properly reflect the potentially adverse consequences that these risks may have on the institution's capital. Moreover, the addition of the "S" provides for sensitivity in evaluating the capital adequacy of the financial institution.

QUESTION 2: <u>RATIO STANDARDS</u>

Although a system of simple ratios is a better alternative than no system at all, ratios are no longer adequate in either the secondary mortgage market or the overall banking industry. The following sources support the widely adopted contention that ratios need to be supplemented by more sophisticated tools to set capital standards in today's complex market.

THE FED LETTER –

Institutions can no longer rely on risk-based capital ratios as indicators of capital strength. The Federal Reserve has concluded that simple ratios – including risk based capital ratios – and traditional rules of thumb no longer suffice in assessing the overall capital adequacy of many banking organizations. This is so because ratios often encourage efforts to restructure transactions simply to receive a lower regulatory capital treatment even though the risk has not changed. Hence, even high capital ratios are often not indicative of overall capital adequacy, especially for institutions engaging in securitization of high quality assets and other capital arbitrage techniques.

As discussed in the first section of this paper a one size fits all regulatory scheme (i.e., ratios) cannot protect the financial system as it is untenable in a world in which banks vary dramatically in terms of size, business mix and appetite for risk. The Fed Letter realizes that in order to remain competitive, individual banks and supervisory policies and practices must evolve and adapt over time. Accordingly, rather than adopting a ratio based scheme, prudential policies should be customized for each institution.

THE BASLE COMMITTEE –

In the past 20 years, a wide range of countries have introduced formalized capital requirements. Initially, this development was spearheaded by the adoption of minimum capital requirements in select countries. However, with the introduction of the Basle Accord in 1988, common minimum capital requirements were adopted by the G-10. Today, the Accord has been implemented by approximately 100 countries worldwide.

The Basle Committee had two main objectives behind the adoption of a single standard for internationally active G-10 banks. First, the Committee believed that the framework would help to strengthen the soundness and stability of the international banking system by encouraging international banking organizations to boost their capital positions. Second, the Committee believed that a standard approach applied to internationally active banks in different countries would reduce competitive inequities. Importantly, the framework established a structure that was intended to:

1) Make regulatory capital more sensitive to differences in risk profiles among banking organizations;

2) Take off-balance sheet exposures explicitly into account in assessing capital adequacy; and

3) Lower the disincentives to holding liquid, low risk assets.

It is now eleven years since an agreement was reached on the Basle Accord and it is therefore important to consider whether the policy achieved the desired objectives. The Basle Committee asked the Research Task Force to set up a Working Party on Bank Capital and Behavior to assess the empirical evidence on the impact of the 1988 Accord before working on amending the Accord was started.

Two main issues were considered by the Working Party. First, whether the adoption of fixed minimum capital requirements led some banks to maintain higher capital ratios than would otherwise have been the case and whether any increase in ratios was achieved by increasing capital or reducing lending. Second, whether the fixed capital requirements have in fact been successful in limiting risk taking by the banks relative to capital as intended, or whether banks have been able to take actions to reduce their effectiveness either by shifting to riskier assets within the same weighting band or through capital arbitrage. The Working Party also considered whether the introduction of fixed minimum capital requirements had unintended side effects, apart from encouraging capital arbitrage activity.

The Working Party found that in some periods, banks were constrained by the capital requirements from increasing lending or may have to reduce lending, thereby causing a credit crunch and affecting the real economy. Further, it found that the introduction of capital requirements for banks may have reduced their competitiveness in relation to other forms of intermediation.

The overall message from the empirical literature and the data is that, the introduction of formal minimum capital requirements across the G-10 appears to have induced relatively weakly capitalized institutions to maintain higher capital ratios. Although it is good to know they have assisted in stability, the ratios were set arbitrarily without any real researched support. I can attest to this fact as I personally participated in setting these standards. Consequently, over time the banks have learnt how to exploit the broad-brush nature of the requirements – in particular the limited relationship between actual risk and the regulatory capital charge.

Adapting to today's markets, in June 1999, the Basle Committee on Banking Supervision decided to introduce a new capital adequacy framework to replace the 1988 Accord. This new capital framework consists of three pillars: minimum capital requirements, a supervisory review process, and effective use of market discipline. With regard to minimum capital requirements, the Committee recognized that a modified version of the existing Accord should remain the "standardized" approach, but that for some sophisticated banks use of internal credit ratings and, at a later stage, portfolio models could contribute to a more accurate assessment of a bank's capital requirement in relation to its particular risk profile. It was also proposed that the Accord's scope of

application be extended, so that it fully captures the risks in a banking group.

In constructing a revised capital framework, the importance of minimum regulatory capital requirements continues to be recognized. This is the first pillar of the framework. The Committee is now stressing the importance of the supervisory review of an institution's capital adequacy and internal assessment process as the second pillar. This requires the use of sensitivity stress testing created by the banks. The third pillar, which the Committee has underlined in recent years, is the need for greater market discipline. Market discipline is of course real time. The Committee believes that, taken together, these three elements are the essential pillars of an effective capital framework.

When the Accord was first established, it was primarily concerned with minimum capital standards to cover credit risk. Insofar as these capital charges covered other types of risk, these were effectively assumed to be proportional to credit risk. Like OFHEO's proposed rule, the Committee now proposes to develop an explicit capital charge for other risks (such as operational risk), and interest rate risk in the banking book for banks where interest rate risks are significantly above average ("outliers"). Such a framework would formally take account of a wider range of actual and potential exposures.

Looking to the future, the Committee believes that the Accord must be responsive to financial innovation and developments in risk management practices. The Committee's longer-term aim is to develop a flexible framework that reflects more accurately the risks to which banks are exposed. Again, ratios alone are no longer adequate.

QUESTION 3: STRINGENCY

In my view, OFHEO's risk-based capital standard creates a very stringent capital standard for the Enterprises. While the full specifications of the stress test are yet to be finalized, the OFHEO capital standard would likely be devastatingly stringent if applied to most other financial institutions.

Institutions can no longer rely on risk-based capital ratios as indicators of capital strength. As the Fed Letter concluded, simple ratios – including risk-based capital ratios – and traditional rules of thumb no longer suffice in assessing the overall capital adequacy of many banking organizations. Ratios often encourage efforts to restructure transactions simply to receive a lower regulatory capital treatment even though the risk has not changed, so even high capital ratios are often not indicative of overall capital adequacy.

Significantly, ratio-based capital standards fail to take interest-rate risk into account. An institution with insufficient capital to support a very large unhedged interest-rate risk position could still meet ratio-based capital standards. In contrast, under the OFHEO risk-based capital standard, an Enterprise with a comparable level of unhedged interest-rate risk would need far higher capital levels to meet regulatory requirements.

This point is illustrated in a study by the Sendero Corporation. As the request of Freddie Mac, the Sendero Corporation applied OFHEO's risk-based capital standard to the thrift industry

as if it were a single entity. That study demonstrated that such a thrift would not survive the 10-year stress period, even starting with more than 9 percent capital. While this would not necessarily be true of all individual thrifts, the study demonstrates the stress test stringency.

The Basle market risk rule does take interest- rate risk into account, but it applies only to an institution's trading book, and it takes into account only two-week movements in interest rates. While the rule then multiplies the results by a factor of three to four to calculate the capital requirement, the result is similar to basing the capital requirement on the amount of capital necessary to withstand a 10-year interest-rate shock greater than anything ever experienced, and then adds 30 percent. Therefore, if the market risk rule were applied to Freddie Mac's or Fannie Mae's portfolio, the resulting capital requirement for interest-rate risk would likely be less than the amount of capital determined under the OFHEO risk-based capital standard.

CONCLUSION

The risk-based capital standard addresses safety and soundness by providing an early warning signal of potential future problems as it can expose hidden weaknesses in a system that seems perfectly healthy and sound under normal conditions. The standard also provides the Enterprises with broad flexibility to choose how to meet the capital standard as the rule does not prescribe capital levels, risk levels, or risk management techniques. Because the standard incorporates the same types of risk considerations already used by the Enterprises, it need not distort business decisions the way simple leverage ratios can. Freddie Mac and Fannie Mae are free to choose how many and what loans to purchase or guarantee, what securities to buy, and how to fund their investment portfolios. The OFHEO risk-based capital standard effectively implements recommendations made by the world's leading regulatory bodies.

In today's environment, the most cost effective approach to prudential oversight will have the regulatory agency tap into an institution's internal risk assessments and management information systems. As internal systems improve, the basic thrust of the examination process should shift from largely duplicating many activities already concluded within the bank to providing constructive feedback that the bank can use to enhance the quality of its risk management systems.

Indeed, it should be emphasized that the focus of supervision and regulation – especially for the larger institutions – should be less on detail and more on the overall structure and operations of risk-management systems. That is the most efficient way to address our interest in both the safety and soundness of the secondary mortgage market and the overall stability of financial markets.

In particular, we believe that OFHEO should avoid mechanical or formulaic approaches that, whether intentionally or not, effectively "lock" the Enterprises into particular technologies long after they become outmoded. We should be planning for the long pull, not developing near-term quick fixes. In sum, it is the framework that we must get right.

Thrift Industry Analysis:

Implications of Risk-Based Capital Stress Test Requirements

August 19, 1999

Prepared by:

IPS Sendero

7272 East Indian School Road, Suite 300
Scottsdale, Arizona 85251

Executive Summary

Last April, the Office of Federal Enterprise Oversight (OFHEO) proposed a risk-based capital stress test to apply to Freddie Mac and to Fannie Mae. At the request of Freddie Mac, we applied the proposed stress test to the thrift industry using aggregate thrift industry data as of June 30, 1997.

Our analysis indicates that the thrift industry would need to triple its capital levels to meet the proposed risk-based capital requirement. The thrift industry fully depletes its capital base of $67 billion just 4½ years into the 10-year test. By the end of the 10-year test, the thrift industry would have deficits of approximately $173.5 billion. The resulting capital requirement (including OFHEO's 30 percent add-on for management and operations risk) is approximately $204 billion, or 27 percent, more than three times their current capital level of the industry.

Since the levels of non-derivative counter-party credit risk "haircuts" specified in the proposal have been questioned by both Enterprises, we also modified the proposed stress test to reduce the "haircuts" by 75 percent, and applied the modified test to the thrift industry. Under this modified scenario, the thrift industry ran out of capital in the fifth year. The resulting capital requirement, including the management and operations risk add-on, was approximately $157 billion or 21 percent.

Project Overview

Freddie Mac asked IPS-Sendero to simulate the thrift industry's financial performance and capital adequacy when subjected to OFHEO's proposed risk-based capital stress test. Thrift industry assets are substantially the same as those of Freddie Mac and Fannie Mae (at the end of the second quarter 1997, 1174 reporting thrift institutions showed total assets of $752 billion, with more than 80 percent of those assets relating to mortgage loans or mortgage-backed securities). Therefore, we were able easily to apply OFHEO's risk-based capital proposal to the thrift industry.[1]

The risk-based capital requirement is based on the up- or down-rate scenario, depending on which would result in the higher risk-based capital requirement. Credit losses for the two stress scenarios were defined from rates obtained by Freddie Mac from OFHEO. Non-mortgage credit risk was based on the non-derivative counterparty credit risk "haircuts".

[1] It may be appropriate for thrifts to have a higher nominal capital requirement than Freddie Mac or Fannie Mae since individual institutions tend to lend within concentrated regions. That lack of geographic diversification creates greater exposure to changes in regional economies. Any resulting risk to taxpayers, however, is lessened by the existence of the Savings Association Insurance Fund ("SAIF"). At the end of March 1999, the SAIF had a fund balance of approximately $9.9 billion. Losses on insured deposits from individual thrift failures would have to exhaust the SAIF's funds before taxpayers would be at risk.

The analysis used aggregate thrift industry data as reported on the June 30, 1997 Office of Thrift Supervision Industry Aggregate Report, Schedule CMR (OFHEO applied the proposal to Freddie Mac and Fannie Mae as of the same date). The analysis also applied other operating statistics obtained from thrift peer groups of IPS-Sendero clients.

The June 30, 1997 profile of thrift industry holdings was subjected to an interest rate stress test for both rising and falling rate scenarios. According to the statute, the up-rate stress test was defined as the 10-year Treasury rate rising from 6.49 percent initially to 11.44 percent over the first year. This rate (11.44 percent) then remained constant throughout the subsequent nine years. The down-rate stress has the 10-year Treasury falling to 3.27% over the same time horizon.

Income simulations were performed using mortgage credit loss and prepayment experience assumptions based on rates provided by OFHEO. Loss rates for non-mortgage assets were based on the "haircuts" described for counterparty credit risk in the proposal. Levels of non-interest income and expense were held constant as a percentage of assets at levels existing at June 30, 1997.

Our analysis includes an additional 50 basis point cost of funds increase for the beginning balance yield, as provided for in the proposal. This mirrors the required increase that Fannie Mae and Freddie Mac are to assume as depicted by the 12 CFR Part 1750 risk based capital rule.

Stress Test Model Assumptions

A number of environmental and operating assumptions are required to make the stress test operational. Aside from the movement of interest rates and schedule for credit loss experience supplied, the proposed regulation requires no recognition of new business or investment be made for the stress test period. Accordingly, balances of interest bearing assets and liabilities were allowed to "runoff" for the two stress test scenarios.

Key Environmental Assumptions

	Description	Source
Treasury interest rates	All points on the Treasury yield curve.	Yield curve rates used were based on the ARIMA processes described in the proposal and were provided to Freddie Mac by OFHEO.
Other market rates/indices	Other key market rates, including Fed Funds, LIBOR, Prime, COFI, mortgage rates.	The rates used in this analysis were based on the ARIMA processes described in the proposal and were provided to Freddie Mac by OFHEO.
Mortgage runoff	The rates by which mortgage balances decline by year, in each stress scenario. Includes balance reduction as a result of amortization, prepayment, and default.	Prepayment and default rates for both stress scenarios were based on rates provided to Freddie Mac by OFHEO. Applied to all mortgage-based assets.
Mortgage credit losses	Losses realized as a result of mortgage defaults.	Credit loss rates for both stress scenarios were based on rates provided to Freddie Mac by OFHEO. Applied to mortgage assets for which the thrift industry accepts credit risk.
Non-mortgage runoff	The rates by which the balances of non-mortgage assets decline.	Balances for non-mortgage assets decline based on the remaining term of the asset group.
Non-mortgage credit losses	Losses realized by thrifts as a result of defaults by borrowers (consumer and commercial loans) or from counterparty credit risk (MBS, CMOs, other investments).	Credit loss rates are based on the "haircuts" for non-derivative counterparty credit risk described in the proposal.
Core deposit decay	Rate at which money market, non-interest bearing, passbook, transaction, and escrow accounts decline over time.	Held constant at baseline of 30% in the down-rate stress scenario. Given strong disintermediation pressures attached to rapidly rising rate moves, the decay rate was assumed to moderately increase to 50% in the up-rate stress scenario.
Refunding issuance/cash reinvestment	Liabilities/assets used in times of cash shortfall or excess.	All projected refunding needs were met through the issuance of short-term debt at the prevailing Fed Funds rate. In periods of cash excess, funds are reinvested at the prevailing Fed Funds rate.
Taxes & dividends	Tax rate of 34% assumed, with 3-year tax loss carryback. Dividend payments were excluded from this analysis.	

Commitments are not included in this analysis due to a lack of industry data, although they would be modeled under the proposal. Their inclusion would add to the capital requirement in both stress scenarios. Off-balance sheet assets similarly are not included. Their effect on the capital requirement could be positive or negative.

Stress Test Model Results

The appendix of this analysis depicts the simulation results for the two stress test scenarios. In the up-rate stress, the interest rate risk resulting from funding long-term assets with short-term deposits leads to net losses in the first year. Losses amounting to $4.27 billion were recorded in the first year of the simulation. By the end of the 53rd month of the 120 month simulation time horizon, the thrift industry has used all of its initial capital and is in a "deficit" equity position. Assuming continued access to short term funding sources, the balance sheet at the end of the ten years shows a capital deficit of almost $173.5 billion. Included in this capital calculation were prior period tax loss carry back credits of approximately $7.6 billion for the first 3 years of the simulation.

The capital deficit at the end of this stress scenario is about $173.5 billion. After inclusion of the 30 percent add-on for management and operations risk, the risk-based capital requirement is 27 percent of initial assets. This capital requirement is more than a threefold increase over capital held by the thrift industry at the start of the stress scenario. An injection of about $137 billion in additional equity at the start of the stress test would enable the thrift industry to maintain positive capital for ten years in this scenario.

In the same up-rate scenario, with "haircuts" reduced by 75 percent, the thrift industry has a capital deficit of about $104 billion at the end of the stress period. Including the management and operations risk add-on, this risk-based capital requirement is about 21 percent of assets.

The down stress test model yields different results. The same short-term funding mode that exposes the thrift industry to rising rate movement proves beneficial in a down-rate stress scenario. Though the thrift industry still loses more than $17 billion over ten years, initial capital is adequate to absorb these losses. Our projections show that the industry would require total capital of $17 billion to survive the down-rate test. The associated $22.1 billion risk-based capital requirement is dwarfed by levels generated in the up-rate stress test. Since the risk-based standard is based on the rate scenario that produces the highest need for risk-based capital, further attention of the down-rate stress test was unwarranted.

$ in Millions	Up Rate Stress	Up-Rate Stress, Reduced Haircuts
Capital Surplus / (deficit) at end of stress test	$ (173,476)	$ (103,594)
Years to failure	4.58 years	5.25 years
Capital Requirement	27.1%	20.9%
Current Capital (%)	8.9%	8.9%
Undercapitalization (%)	18.2%	12.0%
Undercapitalization ($)	$ 137,102	$ 89,963

Note: includes 30% add-on for management and operations risk.

Conclusion

Based on the results generated by the IPS-Sendero income simulation model, the thrift industry would have to substantially increase its current capital levels to comply with the proposed risk-based capital standards. Our estimates show that the thrift industry would need to increase its June 30, 1997, capital base by more than $137 billion (including the 30 percent management and operations risk add-on). This would equate to boosting the thrift industry's capital base over 305 percent to meet the risk-based capital requirement.

Thrift Industry - Qtr 2/97
Balance Sheet
Base Case - Up-Rate Stress

$ in Millions

Year	30-Jun 1997	At year end 1	2	3	4	5	6	7	8	9	10
Assets:											
Cash & Due	$17,268	$15,500	$14,228	$12,968	$11,541	$10,082	$8,971	$8,097	$7,300	$8,698	$6,149
Fed Funds sold	7,772	0	0	0	0	0	0	0	0	0	0
Government & Agency Securities	23,657	20,572	17,486	14,400	11,314	8,229	5,143	2,057	0	0	0
Mortgage Backed Securities	37,888	33,875	29,878	25,370	22,100	19,217	16,655	14,105	11,589	9,292	7,367
CMOs	37,102	31,927	26,556	21,064	15,531	9,972	4,354	0	0	0	0
Corporate Bonds & Other	8,537	7,860	7,184	6,508	5,832	4,888	3,945	3,269	2,592	1,916	1,240
Total Investments	114,956	94,234	80,903	67,342	54,776	42,306	30,097	19,431	14,182	11,208	8,607
ARMs - current index	147,745	139,124	131,952	122,161	111,264	101,269	92,279	84,287	77,131	70,573	84,452
ARMs - lagging index	157,605	148,527	141,014	130,719	119,259	108,782	99,404	91,127	83,783	77,125	70,989
Non residential ARMs	59,579	53,538	47,270	40,900	34,580	28,373	24,022	21,757	19,578	17,459	15,365
Home Equity - variable	11,805	10,765	9,860	8,510	7,344	6,171	4,980	3,777	2,547	1,271	0
Commercial - variable	6,814	5,891	4,768	3,845	2,922	1,999	1,077	154	0	0	0
Consumer - variable	11,563	10,297	8,940	7,509	6,026	4,493	2,894	1,219	0	0	0
Construction - variable	8,477	7,206	5,934	4,662	3,391	2,119	848	0	0	0	0
Total Adjustable and Variable Loans	403,387	375,147	349,537	318,306	284,786	253,206	225,503	202,321	183,037	166,427	150,806
Mortgages - fixed rate	106,203	97,975	89,956	81,297	72,148	62,675	52,982	43,156	33,598	24,820	19,885
Balloon Mtgs.	16,463	12,718	8,942	5,198	2,198	0	0	0	0	0	0
Non residential mortgages - fixed	19,674	16,208	12,631	8,991	5,468	4,429	3,366	2,279	1,154	0	0
Home equity - fixed	9,557	8,534	7,444	6,305	5,135	3,938	2,705	1,429	92	0	0
Commercial - fixed	3,926	3,414	2,902	2,390	1,878	1,366	853	341	0	0	0
Consumer - fixed	17,920	14,996	11,667	8,555	5,083	1,434	0	0	0	0	0
Construction - fixed	4,575	3,889	3,203	2,516	1,830	1,144	458	0	0	0	0
Total Fixed Rate Loans	177,319	157,734	136,945	115,252	93,740	74,988	60,363	47,205	34,845	24,820	19,885
Loan loss reserves	-5,278	-5,278	-5,278	-5,278	-5,278	-5,278	-5,279	-5,278	-5,278	-5,278	-5,278
Other assets	44,282	40,226	36,169	32,113	28,057	24,001	19,945	15,888	11,832	7,776	3,720
Total Assets	$751,934	$677,561	$612,504	$540,701	$467,622	$399,302	$339,601	$287,664	$245,917	$211,651	$183,888

Thrift Industry - Qtr 2/97
Balance Sheet
Base Case - Up-Rate Stress

$ In Millions

	30-Jun	At year end									
Year	1997	1	2	3	4	5	6	7	6	9	10
Liabilities:											
1 Year CD	169,772	0	0	0	0	0	0	0	0	0	0
3 Year CD	110,463	46,802	23,401	0	0	0	0	0	0	0	0
5 Year CD	42,265	32,580	23,124	13,869	6,834	0	0	0	0	0	0
Demand Deposits	29,950	20,965	12,579	6,289	3,145	1,572	786	393	197	98	49
MMDA Accts	59,107	41,375	24,825	12,412	6,206	3,103	1,552	776	388	194	97
Savings Accounts	62,659	43,861	26,317	13,158	6,579	3,290	1,645	822	411	206	103
NOW Accounts	20,371	14,260	6,556	4,278	2,139	1,069	535	267	134	67	33
Escrow Deposits	6,746	0	0	0	0	0	0	0	0	0	0
Total Deposits	501,353	199,842	118,601	49,807	24,904	9,035	4,517	2,259	1,129	565	282
Funds Purchased		311,959	405,692	448,381	428,233	405,931	381,469	363,399	355,775	354,186	381,512
Borrowings - Variable	52,462	52,462	6,744	0	0	0	0	0	0	0	0
Borrowings - Fixed	126,363	46,732	29,005	11,278	9,023	6,767	4,511	2,256	0	0	0
Other Liabilities	10,092	9,188	8,243	7,319	6,394	5,470	4,546	3,621	2,697	1,772	848
Total Liabilities	690,270	620,163	570,486	516,786	468,553	427,202	395,043	371,535	359,601	356,523	362,642
Equity:											
Capital Stock & Surplus	61,664	61,664	61,664	61,664	61,664	61,664	61,664	61,664	81,664	61,664	61,664
Retained Earnings		-4,265	-19,645	-37,749	-62,595	-89,564	-117,107	-145,534	-175,347	-206,536	-240,418
Total Equity	61,664	57,398	42,018	23,915	-931	-27,900	-55,443	-83,871	-113,683	-144,872	-176,754
Total Liabilities & Equity	$751,934	$677,561	$612,504	$540,701	$467,622	$399,302	$339,601	$287,664	$245,917	$211,651	$183,888
Total Capital (Equity + Reserves)	$66,942	$62,677	$47,297	$29,193	$4,347	($22,622)	($50,165)	($78,592)	($108,405)	($139,594)	($173,476)

Thrift Industry - Qtr 2/97
Income Statement
Base Case - Up-Rate Stress

$ in Millions

Year	1	2	3	4	5	6	7	8	9	10
	At year end									
Interest Income										
Fed Funds sold	$58	$0	$0	$0	$0	$0	$0	$0	$0	$0
Government & Agency Securities	1,427	1,228	1,030	828	631	432	233	44	0	0
Mortgage Backed Securities	2,825	2,343	2,050	1,775	1,556	1,355	1,185	978	793	635
CMOs	2,630	2,428	1,981	1,522	1,066	605	155	0	0	0
Corporate Bonds & Other	549	503	458	413	359	296	242	197	151	106
Total Investments	7,289	6,503	5,519	4,538	3,811	2,688	1,794	1,217	944	741
ARMs - current index	11,677	12,940	13,612	13,434	12,413	11,301	10,420	9,736	8,008	8,236
ARMs - lagging index	13,039	18,836	16,727	17,352	15,863	14,488	13,267	12,182	11,209	10,319
Non residential ARMs	5,151	8,498	8,171	5,278	4,399	3,592	3,194	2,884	2,585	2,291
Home Equity - variable	1,493	1,960	1,688	1,416	1,172	941	724	512	305	96
Commercial - variable	818	982	760	589	415	253	99	2	0	0
Consumer - variable	1,888	2,270	1,892	1,507	1,145	788	433	89	0	0
Construction - variable	1,047	1,259	983	718	477	251	47	0	0	0
Total Adjustable and Variable Loans	35,111	44,745	43,853	40,293	35,883	31,614	28,184	25,405	23,106	20,943
Mortgages - fixed rate	8,099	7,495	6,832	6,123	5,361	4,616	3,836	3,080	2,328	1,777
Balloon Mtgs.	1,124	838	551	284	75	0	0	0	0	0
Non residential mortgages - fixed	1,600	1,267	966	643	445	351	254	155	51	0
Home equity - fixed	849	750	645	537	426	312	194	72	0	0
Commercial - fixed	322	277	232	187	142	97	52	10	0	0
Consumer - fixed	1,737	1,417	1,076	720	345	29	0	0	0	0
Construction - fixed	356	296	240	183	125	87	13	0	0	0
Total Fixed Rate Loans	14,087	12,362	10,545	8,676	6,939	5,472	4,350	3,296	2,380	1,777
Total Interest Income	$56,487	$63,810	$59,917	$53,507	$46,434	$39,774	$34,328	$29,918	$26,430	$23,461

Thrift Industry - Qtr 2/97
Income Statement
Base Case - Up-Rate Stress

$ in Millions

	At year end									
Year	1	2	3	4	5	6	7	8	9	10
Interest Expense										
1 Year CD	$4,285	$0	$0	$0	$0	$0	$0	$0	$0	$0
3 Year CD	4,965	2,232	747	0	0	0	0	0	0	0
5 Year CD	2,505	1,677	1,236	884	229	0	0	0	0	0
Demand Deposits	605	394	216	109	55	27	14	7	3	2
MMDA Accts	4,331	4,248	2,339	1,167	584	292	146	73	37	18
Savings Accounts	1,719	1,121	621	309	155	77	39	19	10	5
NOW Accounts	86	58	31	15	8	4	2	1	0	0
Escrow Deposits	0	0	0	0	0	0	0	0	0	0
Total Deposits Expense	18,516	9,928	5,192	2,284	1,030	401	201	100	50	25
Funds Purchased	19,484	48,552	58,973	59,717	56,766	53,470	50,704	48,798	48,228	48,608
Borrowings - Variable	8,659	6,984	152	0	0	0	0	0	0	0
Borrowings - Fixed	4,123	2,462	1,313	659	513	367	221	74	0	0
Total Interest Expense	50,783	67,925	65,630	62,660	58,310	54,238	51,126	48,971	48,278	48,633
Net Interest Income (Expense)	5,704	(4,316)	(5,713)	(9,153)	(11,676)	(14,464)	(16,798)	(19,054)	(21,848)	(25,172)
Mortgage Credit Loss	2,048	2,884	3,084	3,640	3,646	2,990	2,209	1,581	1,067	788
Non Mortgage Credit Loss	1,022	2,796	4,376	5,530	5,801	5,244	5,261	5,652	5,187	5,227
Other non interest income	6,815	6,019	5,398	4,739	4,102	3,520	3,022	2,576	2,242	1,958
Other non interest expense	15,719	14,303	12,627	11,261	9,748	8,364	7,182	6,123	5,328	4,654
Total Income before taxes	($6,470)	($18,260)	($20,603)	($24,846)	($26,969)	($27,543)	($28,428)	($29,813)	($31,188)	($33,882)
Tax Adjustment Credit	(2,205)	(2,900)	(2,500)							
Net Income	($4,265)	($15,360)	($18,103)	($24,846)	($26,969)	($27,543)	($28,428)	($29,813)	($31,188)	($33,882)

Freddie Mac

ABC Bancorp Time Deposits Date: 8/18/99

"Matured instrument has a Current Balance greater than zero" Count: 25

Account Number	Current Balance	Maturity Date
35770000000040038200001	$1,450.39	04/03/1999
35770000000073044000001	$738.90	02/09/1998
35770000002000297200001	$352.24	05/04/1999
38626000000001186100001	$10,420.28	04/30/1999
38626000000001187200001	$21,175.04	02/12/1999
46620000091100314700001	$116,071.90	04/29/1999
46620000091100395700001	$2,104.07	10/14/1998
46620000091100395800001	$2,104.07	10/14/1998
46622000091300049300001	$140,000.00	06/26/1999
46841000091100030600001	$10,000.00	06/30/1999
46841000091100030700001	$7,000.00	06/30/1999
47550000091000116000001	$2,292.93	05/09/1999
47550000095001787800001	$658.52	10/01/1996
47550000095001819400001	$1,298.15	05/20/1999
47550000095002136400001	$360.00	01/19/1999
47553000000001444500001	$4,148.10	06/30/1999
47553000000001444600001	$8,002.68	06/30/1999
47553000091400098700001	$25,956.48	06/25/1999
47553000091400098800001	$16,922.85	06/25/1999
47553000091400098900001	$12,058.28	06/28/1999
47553000091400101700001	$30,000.00	06/29/1999
47553000091400119900001	$76,379.51	06/30/1999
47776000000000023400001	$509.71	01/10/1998
47776000000000023500001	$509.71	01/10/1998
47776000000000454600001	$1,002.89	06/28/1999

Thrift Industry - Qtr 2/97
Balance Sheet
Up Stress - Credit Haircuts @ 25%

$ in Millions

Year	30-Jun 1997	1	2	3	4	5	6	7	8	9	10
		At year end									
Assets:											
Cash & Due	$17,268	$15,500	$14,228	$12,966	$11,541	$10,082	$8,971	$8,097	$7,300	$6,698	$6,149
Fed Funds sold	7,772	0	0	0	0	0	0	0	0	0	0
Government & Agency Securities	23,657	20,572	17,486	14,400	11,314	8,229	5,143	2,057	0	0	0
Mortgage Backed Securities	37,886	33,875	29,678	25,370	22,100	19,217	16,655	14,105	11,589	9,292	7,367
CMOs	37,102	31,927	26,556	21,064	15,531	9,972	4,354	0	0	0	0
Corporate Bonds & Other	8,537	7,860	7,184	6,508	5,832	4,888	3,945	3,269	2,592	1,916	1,240
Total Investments	114,956	94,234	80,903	67,342	54,776	42,306	30,097	19,431	14,182	11,208	8,607
ARMs - current index	147,745	139,124	131,952	122,161	111,264	101,269	92,279	84,287	77,131	70,573	64,452
ARMs - lagging index	157,805	148,527	141,014	130,719	119,259	108,782	99,404	91,127	83,783	77,125	70,989
Non residential ARMs	59,579	53,538	47,270	40,900	34,580	28,373	24,022	21,757	19,576	17,459	15,365
Home Equity - variable	11,805	10,785	9,660	8,510	7,344	6,171	4,960	3,777	2,547	1,271	0
Commercial - variable	6,814	5,691	4,768	3,845	2,922	1,999	1,077	154	0	0	0
Consumer - variable	11,563	10,297	8,940	7,509	6,026	4,493	2,894	1,219	0	0	0
Construction - variable	8,477	7,206	5,934	4,662	3,391	2,119	848	0	0	0	0
Total Adjustable and Variable Loans	403,387	375,147	349,537	318,306	284,766	253,206	225,503	202,321	183,037	166,427	150,806
Mortgages - fixed rate	105,203	97,975	89,956	81,297	72,148	62,875	52,982	43,156	33,598	24,820	19,885
Balloon Mtgs.	16,463	12,718	8,942	5,198	2,198	0	0	0	0	0	0
Non residential mortgages - fixed	19,674	16,208	12,631	8,991	5,468	4,429	3,366	2,279	1,154	0	0
Home equity - fixed	9,557	8,534	7,444	6,305	5,135	3,938	2,705	1,429	92	0	0
Commercial - fixed	3,926	3,414	2,902	2,390	1,878	1,366	853	341	0	0	0
Consumer - fixed	17,920	14,996	11,887	8,555	5,063	1,434	0	0	0	0	0
Construction - fixed	4,575	3,889	3,203	2,516	1,830	1,144	458	0	0	0	0
Total Fixed Rate Loans	177,319	157,734	136,945	115,252	93,740	74,986	60,363	47,205	34,845	24,820	19,885
Loan loss reserves	-5,278	-5,278	-5,278	-5,278	-5,278	-5,278	-5,278	-5,278	-5,278	-5,278	-5,278
Other assets	44,282	40,226	36,169	32,113	28,057	24,001	19,945	15,888	11,832	7,776	3,720
Total Assets	$751,934	$677,561	$612,504	$540,701	$467,622	$399,302	$339,601	$287,664	$245,917	$211,851	$183,888

$ in Millions

Thrift Industry - Qtr 2/97
Balance Sheet
Up Stress - Credit Haircuts @ 25%

Year	30-Jun 1997	1	2	3	4	5	6	7	8	9	10
		At year end									
Liabilities:											
1 Year CD	169,772	0	0	0	0	0	0	0	0	0	0
3 Year CD	110,463	46,802	23,401	0	0	0	0	0	0	0	0
5 Year CD	42,285	32,580	23,124	13,669	6,834	0	0	0	0	0	0
Demand Deposits	29,950	20,965	12,579	6,289	3,145	1,572	786	393	197	98	49
MMDA Accts	59,107	41,375	24,825	12,412	6,206	3,103	1,552	776	388	194	97
Savings Accounts	62,659	43,861	26,317	13,158	6,579	3,290	1,645	822	411	206	103
NOW Accounts	20,371	14,260	8,558	4,278	2,139	1,069	535	267	134	67	33
Escrow Deposits	6,746	0	0	0	0	0	0	0	0	0	0
Total Deposits	501,353	199,842	116,801	49,807	24,904	9,035	4,517	2,259	1,129	565	282
Funds Purchased		311,440	402,738	441,282	415,409	386,294	354,393	327,777	310,031	297,199	291,630
Borrowings - Variable	52,462	52,462	8,744	0	0	0	0	0	0	0	0
Borrowings - Fixed	126,363	46,732	29,005	11,278	9,023	6,767	4,511	2,256	0	0	0
Other Liabilities	10,092	9,168	8,243	7,319	6,394	5,470	4,546	3,621	2,697	1,772	848
Total Liabilities	690,270	619,643	587,531	509,687	455,730	407,566	367,967	335,913	313,857	299,536	292,760
Equity:											
Capital Stock & Surplus	61,664	61,664	61,664	61,664	61,664	61,664	61,664	61,664	61,664	61,664	61,664
Retained Earnings		-3,745	-16,690	-30,650	-49,771	-69,927	-90,030	-109,912	-129,604	-149,549	-170,536
Total Equity	61,664	57,918	44,973	31,014	11,693	-8,264	-28,367	-48,249	-67,940	-87,885	-108,872
Total Liabilities & Equity	$751,934	$677,561	$612,504	$540,701	$467,622	$399,302	$339,601	$287,664	$245,917	$211,651	$183,888
Total Capital (Equity + Reserves)	$66,942	$63,197	$50,252	$36,292	$17,171	($2,985)	($23,088)	($42,970)	($62,662)	($82,607)	($103,594)

Thrift Industry - Qtr 2/97
Income Statement
Up Stress - Credit Haircuts @ 25%

$ in Millions

Year	1	2	3	4	5	6	7	8	9	10
	At year end									
Interest Income										
Fed Funds sold	$58	$0	$0	$0	$0	$0	$0	$0	$0	$0
Government & Agency Securities	1,427	1,228	1,030	826	631	432	233	44	0	0
Mortgage Backed Securities	2,625	2,343	2,050	1,775	1,556	1,355	1,165	978	793	635
CMOs	2,630	2,428	1,981	1,522	1,066	605	155	0	0	0
Corporate Bonds & Other	549	503	458	413	359	296	242	197	151	106
Total Investments	7,289	6,503	5,519	4,538	3,611	2,688	1,794	1,217	944	741
ARMs - current index	11,677	12,940	13,612	13,434	12,413	11,301	10,420	9,736	9,008	8,236
ARMs - lagging index	13,039	18,836	18,727	17,352	15,863	14,488	13,287	12,182	11,209	10,319
Non residential ARMs	5,151	6,498	6,171	5,276	4,399	3,592	3,194	2,884	2,585	2,291
Home Equity - variable	1,493	1,960	1,688	1,416	1,172	941	724	512	305	96
Commercial - variable	816	982	780	589	415	253	99	2	0	0
Consumer - variable	1,688	2,270	1,892	1,507	1,145	788	433	89	0	0
Construction - variable	1,047	1,259	983	716	477	251	47	0	0	0
Total Adjustable and Variable Loans	35,111	44,745	43,853	40,293	35,883	31,614	28,184	25,405	23,106	20,943
Mortgages - fixed rate	8,099	7,495	6,832	6,123	5,381	4,616	3,836	3,060	2,328	1,777
Balloon Mtgs.	1,124	838	551	284	75	0	0	0	0	0
Non residential mortgages - fixed	1,600	1,287	966	643	445	351	254	155	51	0
Home equity - fixed	849	750	645	537	426	312	194	72	0	0
Commercial - fixed	322	277	232	187	142	97	52	10	0	0
Consumer - fixed	1,737	1,417	1,078	720	345	29	0	0	0	0
Construction - fixed	356	298	240	163	125	67	13	0	0	0
Total Fixed Rate Loans	14,067	12,362	10,545	8,676	6,939	5,472	4,350	3,296	2,380	1,777
Total Interest Income	$56,487	$63,610	$59,917	$53,507	$46,434	$39,774	$34,326	$29,918	$26,430	$23,461

Thrift Industry - Qtr 2/97
Income Statement
Up Stress - Credit Haircuts @ 25%

$ in Millions

Year	1	2	3	4	5	6	7	8	9	10
	At year end									
Interest Expense										
1 Year CD	4,285	0	0	0	0	0	0	0	0	0
3 Year CD	4,985	2,232	747	0	0	0	0	0	0	0
5 Year CD	2,505	1,877	1,236	684	229	0	0	0	0	0
Demand Deposits	605	394	218	109	55	27	14	7	3	2
MMDA Accts	4,331	4,248	2,339	1,187	584	292	146	73	37	18
Savings Accounts	1,719	1,121	621	309	155	77	39	19	10	5
NOW Accounts	86	56	31	15	8	4	2	1	0	0
Escrow Deposits	0	0	0	0	0	0	0	0	0	0
Total Deposits Expense	18,516	9,928	5,192	2,284	1,030	401	201	100	50	25
Funds Purchased										
Borrowings - Variable	19,469	48,335	58,308	58,375	54,577	50,291	46,445	43,282	41,252	40,000
Borrowings - Fixed	6,659	6,984	152	0	0	0	0	0	0	0
	4,123	2,462	1,313	659	513	367	221	74	0	0
Total Interest Expense	50,767	67,709	64,965	61,319	56,121	51,058	46,867	43,456	41,302	40,025
Net Interest Income (Expense)	5,720	(4,099)	(5,048)	(7,812)	(9,687)	(11,284)	(12,539)	(13,538)	(14,872)	(16,564)
Mortgage Credit Loss	2,006	2,763	2,887	3,405	3,373	2,663	1,868	1,194	690	421
Non Mortgage Credit Loss	255	699	1,094	1,383	1,450	1,311	1,315	1,413	1,297	1,307
Other non interest income	6,615	6,019	5,398	4,739	4,102	3,520	3,022	2,576	2,242	1,958
Other non interest expense	15,719	14,303	12,827	11,261	9,748	8,364	7,182	8,123	5,328	4,654
Total Income before taxes	(5,645)	(15,845)	(16,459)	(19,122)	(20,156)	(20,103)	(19,882)	(19,891)	(19,945)	(20,987)
Tax Adjustment Credit	(1,900)	(2,900)	(2,500)							
Net Income	($3,745)	($12,945)	($13,959)	($19,122)	($20,156)	($20,103)	($19,882)	($19,891)	($19,945)	($20,987)

Thrift Industry - Qtr 2/97
Balance Sheet
Base Case - Down-Rate Stress

$ In Millions

	30-Jun	At year end									
Year	1997	1	2	3	4	5	6	7	8	9	10
Assets:											
Cash & Due	$17,288	$12,587	$8,153	$5,532	$3,756	$2,608	$2,013	$1,731	$1,576	$1,496	$1,451
Fed Funds sold	7,772	0	0	0	0	0	4,727	23,209	33,871	42,798	49,095
Government & Agency Securities	23,657	20,572	17,486	14,400	11,314	6,229	5,143	2,057	0	0	0
Mortgage Backed Securities	37,888	26,741	14,836	8,361	4,430	1,915	853	221	0	0	0
CMOs	37,102	25,659	13,788	5,607	78	0	0	0	0	0	0
Corporate Bonds & Other	8,537	7,860	7,184	6,508	5,832	5,155	3,945	3,269	2,592	1,916	1,240
Total Investments	114,956	61,032	53,294	34,876	21,654	15,299	14,668	28,755	38,464	44,714	50,335
ARMs - current index	147,745	114,873	82,108	56,592	39,546	27,492	18,542	11,806	6,546	2,123	8
ARMs - lagging index	157,605	122,644	87,787	60,654	42,565	29,814	20,385	13,341	7,905	3,393	252
Non residential ARMs	59,579	41,680	23,091	11,788	6,864	3,662	1,464	0	0	0	0
Home Equity - variable	11,605	8,752	5,255	2,900	1,274	148	0	0	0	0	0
Commercial - variable	6,614	5,943	5,204	4,389	3,492	2,503	1,413	212	0	0	0
Consumer - variable	11,563	8,359	4,788	2,316	587	0	0	0	0	0	0
Construction - variable	8,477	7,540	6,503	5,356	4,086	2,881	1,127	0	0	0	0
Total Adjustable and Variable Loans	403,387	309,791	214,716	143,996	98,414	66,300	42,931	25,359	14,451	5,517	259
Mortgages - fixed rate	105,203	79,132	48,317	28,183	14,647	5,980	2,609	796	0	0	0
Balloon Mtgs.	16,463	8,846	2,375	0	0	0	0	0	0	0	0
Non residential mortgages - fixed	19,674	12,262	5,288	2,138	810	0	0	0	0	0	0
Home equity - fixed	9,557	6,929	3,982	1,980	579	0	0	0	0	0	0
Commercial - fixed	3,926	3,550	3,140	2,693	2,205	1,672	1,090	455	0	0	0
Consumer - fixed	17,920	12,121	5,956	1,657	0	0	0	0	0	0	0
Construction - fixed	4,575	3,889	3,203	2,516	1,830	1,144	458	0	0	0	0
Total Fixed Rate Loans	177,319	126,730	72,261	39,167	20,071	6,795	4,156	1,252	0	0	0
Loan loss reserves	-5,276	-5,278	-5,276	-5,276	-5,276	-5,278	-5,276	-5,278	-5,278	-5,278	-5,278
Other assets	44,282	40,226	38,169	32,113	26,057	24,001	19,945	15,888	11,832	7,776	3,720
Total Assets	$751,934	$565,087	$379,316	$250,406	$166,673	$111,725	$78,434	$67,707	$59,044	$54,224	$50,486

Thrift Industry - Qtr 2/97
Balance Sheet
Base Case - Down-Rate Stress

$ in Millions

Year	30-Jun 1997	1	2	3	4	5	6	7	8	9	10
		At year end									
Liabilities:											
1 Year CD	169,772	0	0	0	0	0	0	0	0	0	0
3 Year CD	110,463	48,802	23,401	0	0	0	0	0	0	0	0
5 Year CD	42,265	32,580	23,124	13,669	6,834	0	0	0	0	0	0
Demand Deposits	29,950	20,965	14,675	10,273	7,191	5,034	3,524	2,467	1,727	1,209	846
MMDA Accts	59,107	41,375	26,962	20,274	14,192	9,934	6,954	4,868	3,407	2,385	1,670
Savings Accounts	62,659	43,861	30,703	21,492	15,044	10,531	7,372	5,160	3,612	2,528	1,770
NOW Accounts	20,371	14,260	9,982	6,987	4,891	3,424	2,397	1,676	1,174	822	575
Escrow Deposits	6,746	0	0	0	0	0	0	0	0	0	0
Total Deposits	501,353	199,842	130,846	72,695	48,152	28,923	20,246	14,172	9,920	6,944	4,861
Funds Purchased		194,596	143,015	101,960	49,651	19,922	0	0	0	0	0
Borrowings - Variable	52,462	52,462	8,744	0	0	0	0	0	0	0	0
Borrowings - Fixed	126,363	46,732	29,005	11,276	9,023	6,767	4,511	2,256	0	0	0
Other Liabilities	10,092	9,186	6,243	7,319	6,394	5,470	4,546	3,621	2,697	1,772	848
Total Liabilities	690,270	502,800	319,855	193,251	113,220	61,081	29,303	20,049	12,617	8,717	5,709
Equity:											
Capital Stock & Surplus	61,664	61,664	61,664	61,664	61,664	61,664	61,664	61,664	61,664	61,664	61,664
Retained Earnings		624	-2,203	-4,509	-8,211	-11,020	-12,532	-14,005	-15,237	-16,156	-16,886
Total Equity	61,664	62,267	59,461	57,155	53,453	50,643	49,132	47,659	46,427	45,508	44,776
Total Liabilities & Equity	$751,934	$565,067	$379,316	$250,406	$166,673	$111,725	$78,434	$67,707	$59,044	$54,224	$50,486
Total Capital (Equity + Reserves)	$66,942	$67,566	$64,739	$62,433	$58,731	$55,922	$54,410	$52,937	$51,705	$50,786	$50,056

Thrift Industry - Qtr 2/97
Income Statement
Base Case - Down-Rate Stress

$ in Millions

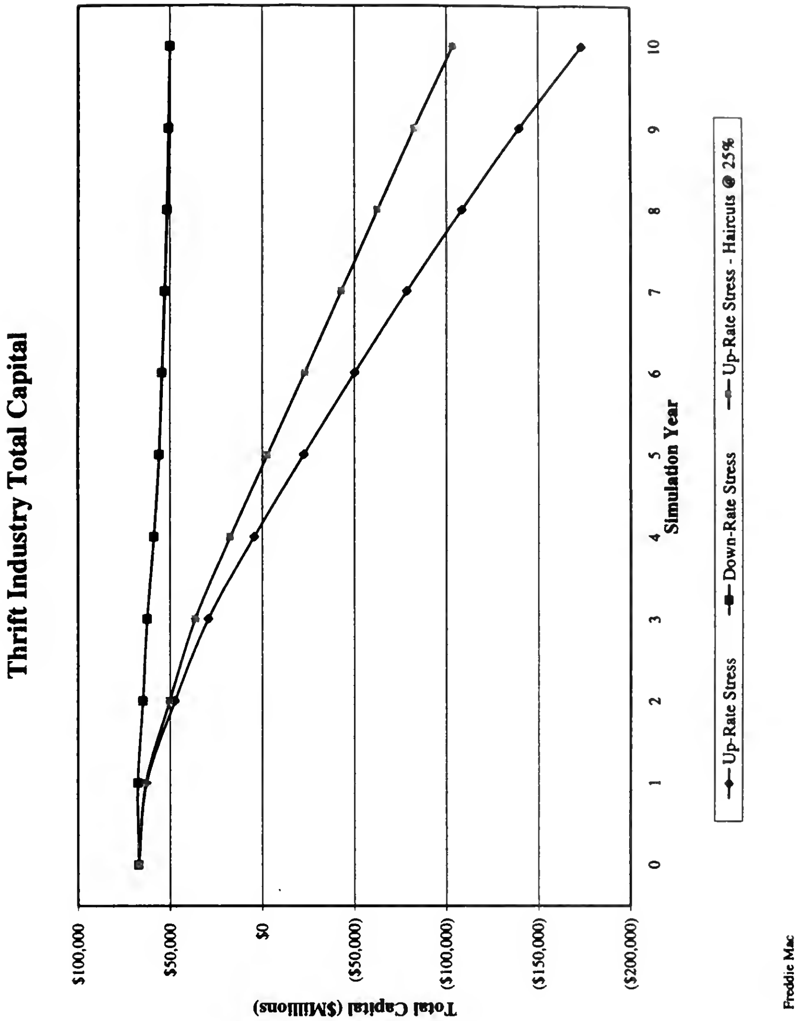
	At year end									
Year	1	2	3	4	5	6	7	8	9	10
Interest Income										
Fed Funds sold	$56	$0	$0	$0	$0	$14	$388	$779	$1,021	$1,235
Government & Agency Securities	1,427	1,228	1,030	828	631	432	233	44	0	0
Mortgage Backed Securities	2,451	1,503	846	472	234	102	39	5	0	0
CMOs	1,904	957	464	125	0	0	0	0	0	0
Corporate Bonds & Other	549	503	458	413	367	289	242	197	151	106
Total Investments	6,386	4,192	2,799	1,838	1,232	836	902	1,025	1,172	1,341
ARMs - current index	9,936	6,044	3,891	2,595	1,774	1,219	803	487	230	39
ARMs - lagging index	10,329	6,273	4,168	2,916	2,051	1,423	955	601	319	94
Non residential ARMs	4,137	1,843	876	467	265	128	33	0	0	0
Home Equity - variable	885	376	209	103	34	1	0	0	0	0
Commercial - variable	494	276	226	161	135	86	36	1	0	0
Consumer - variable	1,273	636	334	133	12	0	0	0	0	0
Construction - variable	677	380	307	237	167	92	18	0	0	0
Total Adjustable and Variable Loans	27,732	15,827	10,034	6,634	4,436	2,950	1,845	1,089	549	133
Mortgages - fixed rate	7,605	4,984	2,999	1,670	795	325	127	21	0	0
Balloon Mtgs.	1,016	405	68	0	0	0	0	0	0	0
Non residential mortgages - fixed	1,476	757	298	129	30	0	0	0	0	0
Home equity - fixed	799	502	274	116	14	0	0	0	0	0
Commercial - fixed	328	294	256	215	171	122	68	13	0	0
Consumer - fixed	1,634	932	389	42	0	0	0	0	0	0
Construction - fixed	356	298	240	183	125	67	13	0	0	0
Total Fixed Rate Loans	13,213	6,172	4,524	2,355	1,134	514	208	35	0	0
Total Interest Income	$47,331	$28,191	$17,356	$10,826	$6,802	$4,299	$2,956	$2,148	$1,721	$1,474

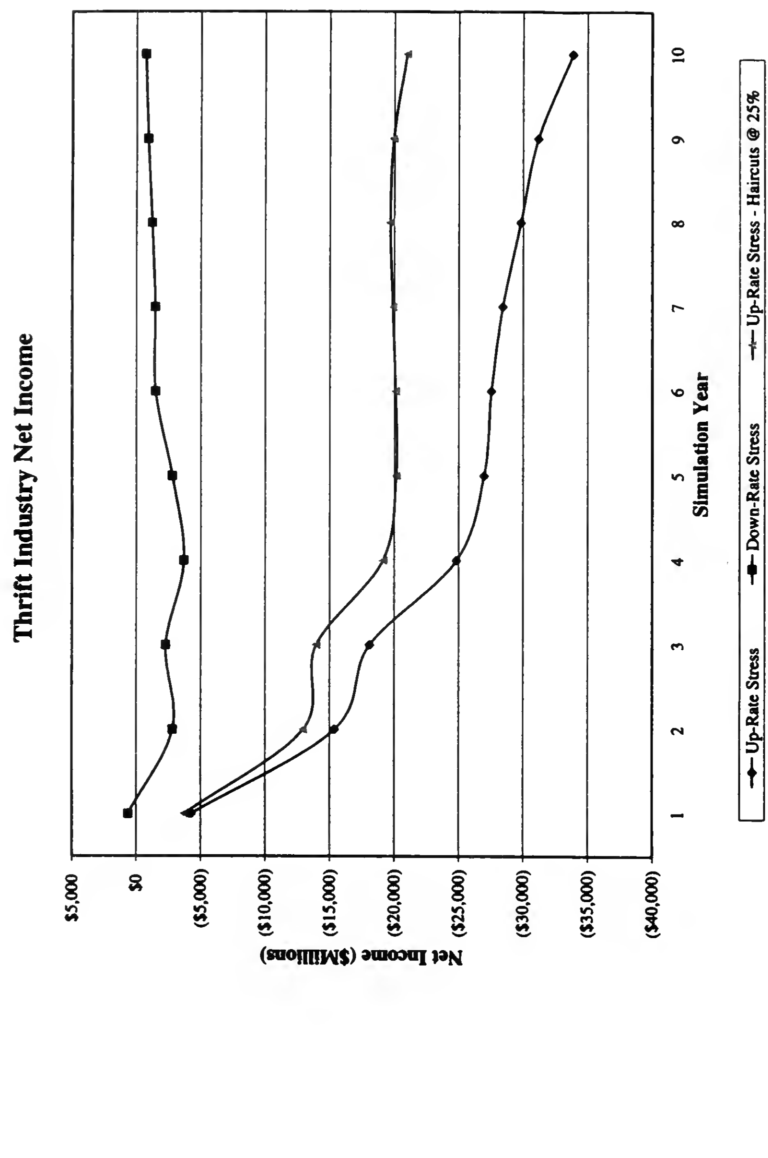
Thrift Industry - Qtr 2/97
Income Statement
Base Case - Down-Rate Stress

$ in Millions

Year	At year end 1	2	3	4	5	6	7	8	9	10
Interest Expense										
1 Year CD	4,265	0	0	0	0	0	0	0	0	0
3 Year CD	4,965	2,232	747	0	0	0	0	0	0	0
5 Year CD	2,505	1,677	1,236	684	229	0	0	0	0	0
Demand Deposits	605	424	297	207	145	102	71	50	35	24
MMDA Accts	2,069	895	629	440	308	218	151	106	74	52
Savings Accounts	1,719	1,204	844	589	413	289	203	141	99	69
NOW Accounts	86	60	42	29	21	14	10	7	5	3
Escrow Deposits	0	0	0	0	0	0	0	0	0	0
Total Deposits Expense	16,273	6,692	3,795	1,949	1,116	621	435	304	213	149
Funds Purchased	5,979	4,237	3,258	1,954	893	192	0	0	0	0
Borrowings - Variable	7,128	4,121	89	0	0	0	0	0	0	0
Borrowings - Fixed	4,123	2,462	1,313	659	513	367	221	74	0	0
Total Interest Expense	33,504	17,511	8,455	4,563	2,521	1,180	656	377	213	149
Net Interest Income (Expense)	13,628	10,680	6,901	6,265	4,281	3,119	2,300	1,771	1,508	1,325
Mortgage Credit Loss	2,295	4,076	3,508	3,185	2,093	1,627	1,270	882	540	362
Non Mortgage Credit Loss	1,992	4,777	4,700	3,903	3,021	1,684	1,681	1,679	1,656	1,620
Other non interest income	6,246	4,439	3,043	2,091	1,436	959	597	321	167	53
Other non interest expense	14,842	10,549	7,231	4,970	3,411	2,279	1,419	764	398	126
Total Income before taxes	945	(4,283)	(3,494)	(3,702)	(2,810)	(1,512)	(1,473)	(1,232)	(919)	(730)
Tax Adjustment (Credit)	321	(1,456)	(1,188)							
Net Income	$624	($2,827)	($2,306)	($3,702)	($2,810)	($1,512)	($1,473)	($1,232)	($919)	($730)

Freddie Mac


Thrift Industry Total Capital
Total Capital ($Millions)
$100,000
$50,000
$0
($50,000)
($100,000)
($150,000)
($200,000)
0
1
2
3
4
5
6
7
8
9
10
Simulation Year
Up-Rate Stress
Down-Rate Stress
Up-Rate Stress - Haircuts @ 25%
Freddie Mac


Thrift Industry Net Income
Net Income ($Millions)
$5,000
$0
($5,000)
($10,000)
($15,000)
($20,000)
($25,000)
($30,000)
($35,000)
($40,000)
1
2
3
4
5
6
7
8
9
10
Simulation Year
Up-Rate Stress
Down-Rate Stress
Up-Rate Stress - Haircuts @ 25%

Freddie Mac

Statement of Curtis L. Hage
Chairman of the
Council of Federal Home Loan Banks

Regarding H.R. 3703, The Housing Finance Regulatory Improvement Act of 2000

Before the Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises of the Committee of Banking and Financial Services

U.S. House of Representatives

Washington, DC
May 16, 2000

Introduction

Good morning, Chairman Baker, Congressman Kanjorski and Members of the Subcommittee, my name is Curt Hage and my bank, Home Federal Savings Bank of Sioux Falls, South Dakota is one of over 7,400 owners of the Federal Home Loan Bank (FHLBank) system. We have been members of the FHLBank of Des Moines since its founding in 1932, and I am here today to tell you that partnership with the FHLBank of Des Moines is very important to our bank's success. Moreover, our success is important to the communities, small and large, that we serve in South Dakota

For disclosure purposes, I should mention that I wear several hats. I am a member of the Board of Directors of the FHLBank of Des Moines; the 2nd Vice Chair of America's Community Bankers; and serve as Chair of the Council of Federal Home Loan Banks (the Council). I am here today on behalf of the Council.

Mr. Chairman and Congressman Kanjorski, I would like to take this opportunity to publicly thank you both for the extraordinary effort you have put forth over the years to enact legislation to modernize the FHLBank system. Your leadership and efforts came to fruition with the passage of the Federal Home Loan Bank System Modernization Act of 1999 (the Modernization Act), which was Title VI of the Gramm-Leach-Bliley Act. The changes resulting from that legislation are significant in many ways.

First, the legislation decentralized management of the FHLBanks, delegating it to the Boards of Directors of each respective FHLBank. Local governance decisions are most effectively and most timely made at the local Board of Director level.

Second, "leveling the playing field" of membership status was an important change. Permitting voluntary membership for all members guarantees that all members can access the FHLBank system on equal terms.

Third, the addition of small business loans, small farm and agri-business loans as eligible collateral enables smaller community financial institutions, those with assets below $500 million, to access funding from their FHLBank. This new funding source is critical to communities throughout the country, but no more so than in the Des Moines district where this category applies to over 95% of the FHLBank's membership (over 1,000 small bank and thrift members.) As more and more deposits to flow out of the banking system, sources of funding for loans become increasingly difficult. This negatively impacts credit availability. Without that dependable source of low-cost funds, financial institutions, like Home Federal, cannot make residential housing, community development and small business loans. And without those loans, communities around the country will begin to atrophy.

Finally, thanks to this legislation, the capital structure of the FHLBank system is being revised for the first time in 68 years. This is an extremely important and dramatic revision for the FHLBanks and their membership. If carefully crafted with coordination and support from the FHLBanks members, it can improve an already strong system. On the other hand, if done without member input and coordination, it could trigger unintended negative consequences.

Again, Mr. Chairman, we want to emphasize how constructive you were in the legislative process over the last several years and know that your intentions with H.R. 3703 are constructive as well.

General Overview of Federal Home Loan Bank System

There are three key points I'd like to make here today. The first is that the FHLBanks are unique. The FHLBank system is a child of the depression, created in 1932. It was designed to partner with local financial institutions that were starved for liquidity and unable to lend. The FHLBanks' liquidity mandate is no less important today than it was 70 years ago.

The FHLBanks are fully capitalized by their members, not the government. It is upon this private equity base that the system has raised the funds that allow for $400 billion in advances to fund housing and community lending, $200 million in affordable housing grants throughout the country and $400 million in Resolution Funding Corporation bond payments. And those are just the numbers expected for this year.

The FHLBanks are growing because their members' needs are growing. In 1990 there were just over 3,000 mutual funds in the country with assets of slightly over $1 trillion. Today there are over 7,500 mutual funds and their assets exceed $7 trillion. A great deal of that growth came from what used to be deposits in local banks. Yet, in spite of this massive deposit drain, banks and thrifts continue to flourish and provide credit to their communities, due in no small part to the role that the FHLBanks play in providing a dependable, low cost source of funds.

This brings me to my second key point of the day: The FHLBanks fill this funding need in a very safe and sound manner. We are subject to annual safety and soundness exams. We have, by regulation and practice, an extremely low tolerance for credit and interest rate risk. Furthermore, the FHLBanks are managed to be stable resources for their members at all points

during a business cycle and that serves as a powerful incentive to avoid significant risk taking.

Finally, the third point I want to make today is that the biggest job facing the FHLBank system is the daunting task of capital restructuring. It is in the context of that challenge that I'd like to discuss H.R. 3703.

Issues Raised by H.R. 3703

Regulatory Structure

As an owner of the FHLBank of Des Moines, and as someone who experienced S&L crisis of the late 1980s, I want to emphasize that the most important responsibility of the regulator of the FHLBanks is to ensure safety and soundness of the system. This is especially true as the FHLBank system implements the significant changes mandated by the Modernization Act. Obviously, determining compliance is also an important regulatory function but it should extend only to ensuring that the congressional intent is met.

The sweeping capital changes of the Modernization Act require all FHLBanks to prepare to implement a new capital structure. These capital requirements will not only impact the FHLBanks' balance sheets, but also effect the stock purchase requirement for each member financial institution. Many complex issues and decisions need to be made and broadly understood to create a sound new permanent capital structure. In the new capital structure where members will take on new risks (including credit risk and what is likely to be a different risk based capital requirement) they will need to receive an adequate return to compensate them for increased risks. The FHLBanks will need to generate sufficient earnings to compensate members for holding permanent capital.

Recently, the Federal Housing Finance Board (FHFB) approved a new proposed rule defining "core mission activities" that could additionally impact the make-up of the FHLBanks' balance sheet. The Council is concerned that the proposal may limit the FHLBanks' ability to generate sufficient earnings in all economic cycles. The Council believes that any mission asset regulation needs to consider the effect of investment limitations and provide the FHLBanks with sufficient flexibility so that they can invest in asset classes, such as mortgage backed securities (MBS) where necessary to generate a sufficient return to their members. If we can ensure a sufficient return we can assure a strong capital base for the system.

Super Lien Authority

Although one of the key skills of the FHLBanks is handling financial risk, we tend to face very little credit risk in the course of our day-to-day business. In fact the system has never experienced a credit loss. There are at least two reasons for this. All FHLBank advances are fully collateralized. In addition, the FHLBanks have certain statutory lien protections for any collateral a member pledges. H.R. 3703 proposes removing this authority in Section 138. In our view, that removal is problematic and serves no purpose.

Current law requires the FHLBanks to secure their loans with specified collateral. Rather than identifying, assigning or perfecting that collateral (a costly and time-consuming process), well-capitalized community banks and other portfolio lenders may use a blanket lien to cover their entire portfolio of eligible collateral. This is practical, efficient and holds down the cost of advances and the administrative burdens for both the membership and the FHLBank. Furthermore, in the event of a loss by a financial institution, the super lien (like a perfected lien) would have first claim on the failed bank's assets. Removing the super lien would not, as some purport, place the Federal Deposit Insurance Corporation (FDIC) in a better position in the event

of a bank failure. Without the super lien the FHLBanks would perfect their security interests and thus have a first claim on the assets. Thus, eliminating the super lien would not change the FDIC's position at all.

Finally, removing this authority from the FHLBanks would be a huge burden on our members. Now they can readily access their line of credit from the FHLBanks and in a matter of minutes secure the funding they need to transact their business. If this authority were removed, and the FHLBanks and their membership have to go through the process of perfecting liens on specific collateral, the process could take days.

We see no benefit to this provision and we strongly oppose it.

Treasury Line-of-Credit

As we have recently seen, comments by senior Treasury officials stating that Treasury's line of credit to GSEs is merely symbolic spooked the capital markets and raised the cost of bonds for FHLBanks and others. That line of credit, however symbolic, gives the FHLBanks better access to low cost funds which, in turn, provides our 7,400 members with better advance rates. And our members, in turn, provide their customers with lower costs of credit. Our line of credit must be handled cautiously to prevent dramatic increases in the cost of funds, particularly for institutions like ours that are chartered to meet affordable housing and community development needs.

New Activities

Currently, when a FHLBank wants to undertake a new program, the FHLBank must generally follow the steps outlined in Section 110. We are, however, concerned that the public comment period currently described in the legislation would hinder the advancement of new products or activities. The fact is that as

a cooperative owned by its members, no FHLBank would attempt to market a product that is not supported by bank membership. In fact, the Council recently signed and sent a joint letter with the American Bankers Association, the America's Community Bankers and the Independent Community Bankers of America to the FHFB, which incorporated a statement that we believe is the proper guideline for the FHLBanks. It said the FHLBanks should:

> "Only develop, approve, or implement activities or programs, consistent with the system's user-cooperative structure, that do not use their GSE advantage to unfairly compete directly or indirectly with the system's shareholders or subsume the roles of the shareholders;"

Limitations of Non-mission Related Assets

We are opposed to arbitrary limitations to the FHLBanks' ability to manage its balance sheet in both good economic times and bad. The FHLBanks' credit loss-free record is due in great part to the management of the FHLBanks and the flexibility they have had to manage their balance sheets in difficult times. For example, the FHFB currently limits our purchase of MBS to three times capital. We believe that limitation is an overly restrictive limitation and, consequently, we are definitely opposed to anything more restrictive. MBS are readily tradable commodities that our members use daily, are very low-risk and are ideal investments in which to invest surplus FHLBanks funds, as provided for in statute. The housing finance market is a cyclical business, which means our advances business is also cyclical. MBS has been critical to the FHLBanks in managing that cyclicality.

Summary

In summary, Mr. Chairman, Congressman Kanjorski, although the FHLBanks – unique among the GSEs – face a tremendous challenge this year to create and

implement a new capital structure, we are prepared for the task. But to succeed they need to remain safe, sound and undiverted from the job at hand. We ask for your support in allowing us to maintain this focus. We have attached comments on specific sections of the bill to this testimony that further illuminate our thoughts on H.R. 3703. I would be happy to answer any questions you many have.

An Analysis of Key Sections in H.R. 3703, the "Housing Finance Regulatory Improvement Act of 2000"

Purpose: This Act is to consolidate regulation of the three housing-related government-sponsored enterprises, Fannie Mae, Freddie Mac and the Federal Home Loan Banks (FHLBanks), under a newly created agency (the Housing Finance Oversight Board) that would replace OFHEO (which currently regulates Fannie Mae and Freddie Mac) and the Federal Housing Finance Board. The new Board also would succeed to HUD's current regulatory responsibility vis-à-vis mission achievement by Fannie Mae and Freddie Mac. The purpose for introducing the bill is the view that combining safety and soundness regulation and mission achievement regulation over the three housing GSEs under a single regulator would lead to more effective and efficient regulation.

Impact to FHLBanks: The Act makes a number of significant changes that would impact the FHLBanks beyond simply having a new regulator. Among these are:

- Elimination of FHLBanks existing super lien protection
- Repeal of Treasury's back-up lines of credit
- New approval requirements for any new business activities
- New threshold for a FHLBank's placement in receivership
- New regulatory limits on non-mission-related assets
- Equal treatment of private label mortgage-backed securities (MBS)

A section-by-section review of the sections of the Act most important to the FHLBanks follows:

Section 101. This section would establish the new Oversight Board with five full-time members. Its composition includes the Secretaries of HUD and Treasury (or their designees, provided such designees are appointed by the President with the consent of the Senate) plus three U. S. citizens (with appropriate financial or regulatory experience) appointed by the President. No more than three Board members can come from the same political party. Board members' terms are six years (or as long as the Secretary or the Secretary's designee remains in that position); initial terms of the three appointed members are staggered.

Comment: While Congress has the responsibility to set up the regulatory framework for the GSEs, we believe the proposed makeup of this Board is not the best structure for promoting unbiased and strong safety and soundness regulation. Consistent with the purpose of the Act, the primary focus of any new regulator should be safety and soundness of the GSEs. The regulatory role in regard to mission should be ensuring that any specific goals established for a GSE by statute should be met. While the

Council does not take a position on whether a single regulator for all three housing-related GSEs could fulfill this role better than the current two regulators, the Council does feel strongly that any effective regulator must be as non-political and unbiased as practicably possible.

Sections 102 through 115 (except for Sections 103, 106, 110 and 111). These sections enumerate the duties and authorities of the new Board, how it would succeed to the personnel, resources and assessment powers of the Finance Board, OFHEO and HUD (in certain areas) and how the Board should enforce its new duties via regulations. While many of the enumerated duties and authorities are consistent with those of existing regulators, there are areas of concern, as noted below.

Sections 103 and 106. These sections would impose additional public disclosure requirements regarding financial, business and related information, as well as regulatory orders and agreements, on the FHLBanks, Fannie and Freddie.

Comment: While the Council supports legitimate disclosure requirements, the Council is concerned about the extent to which any new requirements would generate additional costs and burdens for the FHLBanks with little additional public benefits. In this regard, requiring the regulator to do some type of cost/benefit assessment before imposing additional disclosure requirements seems appropriate.

Sections 110. Section110 would require prior Board approval before any "new activity" can be conducted by any of the three GSEs.

Comment: It is also vitally important that new activities be developed in close coordination with their FHLBank members to ensure member participation, which is vital to success of any new activity. In the context of the FHLBanks, which are cooperatives that serve their member-stockholders, it is important regarding new business activities that the needs of and impact on FHLBank members of any new business activity be fully considered. This is something that needs to be done by the FHLBanks themselves at the regional and local levels; a regulator isolated inside the Washington beltway cannot effectively accomplish this. Accordingly, the Council believes the Act should clarify the role of the regulator in this area. Its role should be limited to reviewing proposed new activities and asset composition from a safety and soundness standpoint as well as the statutory parameters set out by Congress in order to determine that the new business activity is consistent with the charter established for the GSE by Congress. In addition, any regulatory review process must be expeditious and effective insofar as the GSEs are concerned.

Section 111. This section would require the Board, by regulation, to limit the non mission-related assets held by any of the GSEs. The Act would give the Board wide latitude in deciding what "new activities" would require approval and how to define "nonmission-related assets."

Comment: This section needs to be revised. By giving the Board broad powers to determine how "nonmission-related assets" can be defined and what nonmission-related assets limits should be imposed, the Act could easily deprive a GSE of the ability to effectively manage its balance sheet in all business cycles. As previously noted, the Council fully supports the regulator's role in ensuring any "new activities," as well as "mission" and "nonmission" related assets of a GSE are conducted consistently with safety and soundness. However, it is Congress' role to define the mission parameters. In the case of the FHLBanks, which as lenders to their members serve as liquidity providers, it seems clear that MBS are consistent with their congressionally defined purpose of providing support for housing and ensuring an adequate central system of liquidity for community financial institutions that finance housing. MBS are a readily tradable commodity that our members use daily that offer a very low-risk investment. Our activity in this market helps to provide market stabilization and is an ideal investment, as provided for in statute, for the FHLBanks to invest surplus funds. The housing finance market is a cyclical business, which means our advances business is also cyclical. MBS has been crucial in managing that cyclicality.

Section 135. This section provides for the appointment of a qualified receiver by the Board for Fannie or Freddie, if the GSE should become "critically undercapitalized" and for any FHLB that fails to meet its capital requirements.

Comment: The threshold for a Home Loan Bank to go into receivership is significantly low (i.e. fail one capital requirement). The threshold should be the industry accepted standard for financial institutions (i.e. FDICIA standards) rather than this low artificial standard.

Section 136. This would repeal and remove the long-standing lines of credit extended from the U. S. Treasury to each of the three GSEs.

Comment: The Council believes this repeal would be unwise and counterproductive, since it would lead to higher costs for GSE funding and correspondingly higher costs for housing. These back-up lines of credit have rarely, if ever, been used and provide a flexible and convenient vehicle for the Treasury to provide support to a GSE in the unlikely event that such action is required. The existence of a strong and continuous framework of safety and soundness regulation for the GSEs provides appropriate protection against the need to use these back-up lines of credit.

Section 138. This section would remove the FHLBanks' super-lien status vis-à-vis the FDIC and other creditors of depository institutions with respect to assets pledged to secure advances.

Comment: The provision is unacceptable since it would effectively eliminate the FHLBanks' ability to use a "blanket lien" to secure advances and, consequently, cause significant unneeded regulatory costs and burdens for many borrowing members. This would be particularly difficult for smaller members who rely on the "blanket lien" to liquefy their entire non-conforming residential mortgage loan portfolios. In addition, both the FHLBanks' super-lien and perfected lien have the first claim on assets in the event of a bank's liquidation or failure. Consequently, repeal of the super-lien authority would not place the FDIC in a better position when a bank failure occurs, since the FHLBanks would protect their priority claim against their collateral by holding a perfected security interest in the failed bank's assets. As a perfected secured creditor the FHLBank's claim would still have priority over the FDIC. Eliminating the super lien would merely raise the cost of credit that member financial institutions provide to their communities not put the FDIC in a better position.

Section 140. This provision expresses Congressional preference for the proposed regulatory rules issued by the Federal Reserve, FDIC, OCC and OTS that give AAA-rated private label MBS the same risk-based capital treatment as agency MBS.

Comment: The provision is clearly a positive step in reinforcing the need for and correctness of equalizing capital treatment for securities that carry the same level of credit risk.

Sections 161 to 204. These are the remaining sections of the bill, which contain technical provisions and conforming amendments to existing law. They deal with abolishment of OFHEO and the Finance Board (since the Oversight Board replaces them), transfer of OFHEO and Finance Board employees and property to the Oversight Board and the effective date of the new Act, which is 270 days after its enactment.

Comment: The Council is concerned that the mere existence of these provisions, without providing some certainty for employment, could cause instability in the regulatory agencies personnel which clearly would not be a goal of the legislation. Consequently, clarification of the status of affected personnel in the Act itself would seem desirable.

Mitchell Delk
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May 15, 2000

The Honorable Ed Royce
U.S. House of Representatives
1133 Longworth House Office Building
Washington, D.C. 20515

Freddie Mac

Dear Congressman Royce:

Thank you for taking the time and effort to acquaint yourself with Freddie Mac's agreement to provide our automated underwriting technologies (Loan Prospector) and other support to HomeAdvisor Technologies, Inc. I wanted to follow up our meeting with some additional information and clarify some misperceptions that have been reported in the press about our involvement in HomeAdvisor Technologies, Inc.

As we discussed, HomeAdvisor Technologies, Inc. is a new company that Microsoft is creating with the support of a range of mortgage industry leaders. Our relationship with HomeAdvisor is aimed at providing mortgage lenders using HomeAdvisor's services with a host of tools to promote access to mortgage credit. Through our relationship, we are once again leading the industry in innovative solutions, lowering costs for consumers and promoting the ability of our lending customers to obtain internet lending capabilities that they will control and operate in their own names.

Innovation is a hallmark of competition in the private sector. Throughout our history, Freddie Mac has been a pioneer in innovation, exploring new frontiers that hold the promise of creating a faster, more efficient and less costly mortgage finance system for consumers throughout the Nation. Along the way, Freddie Mac has taken steps to improve every aspect of the mortgage finance system and to reduce the cost of homeownership.

Our relationship with HomeAdvisor is just the type of pathbreaking innovation that promises extraordinary benefits to homebuying families. Our statutory purposes require us to promote access to mortgage credit throughout the nation. We believe that we can save families up to two thousand dollars per loan on closing costs if we streamline the processing of mortgages using internet technologies. This is the type of breakthrough that can usher an entire generation of families through the doors of homeownership.

Our agreement with HomeAdvisor also promises to benefit our lending customers. Freddie Mac believes that HomeAdvisor will level the playing field by helping all lenders capture the benefits of Internet mortgage channels by reaching new and existing customers. This is especially true for smaller lending institutions, credit unions and other

lenders who lack the capital and expertise to build their own internet-based lending systems, and, once HomeAdvisor Technologies, Inc. is up and running, will be able to obtain Internet lending capabilities from HomeAdvisor.

Providing our secondary market tools for use with internet technologies does not change the purpose or effect of Freddie Mac's role in the world of mortgage finance: In this arrangement, as in all of our activities, we continue to do what we have done for the past 30 years – serve as a reliable partner to mortgage lenders of all kinds. We have neither the intention nor the authority to originate mortgage loans, nor to engage in direct mortgage transactions with consumers. Freddie Mac, like all mortgage market participants, must respond appropriately to the changes the Internet is bring to the mortgage marketplace. This "next generation" of technology, designed for Freddie Mac seller/servicers who wish to make mortgage loans on line, does not constitute an expansion of our activities, it simply delivers them in another way.

Unfortunately, media and other accounts purporting to describe Freddie Mac's relationship with HomeAdvisor create a misleading impression both of our purposes for entering the arrangement and the nature of the arrangement. Let me correct some of these misperceptions. First, HomeAdvisor Technologies will neither fund nor close mortgage loans. Mortgages made through these Internet operations will be approved, funded and sold to Freddie Mac *only* by a mortgage lender that is an approved Freddie Mac Seller/Servicer. Neither HomeAdvisor itself nor Microsoft is entering the lending business.

Second, Freddie Mac will not be the only purchaser of closed mortgages sourced through HomeAdvisor. A number of secondary market investors are likely to participate in this business, providing opportunities for lending institutions to fund loans for their own portfolios or to partner with secondary market investors or both. Of course, we hope that lenders will partner with us, but that is a matter of lender choice and not of business design.

Finally, let me address the concerns regarding our financial interest in HomeAdvisor Technologies. Our agreement calls for Freddie Mac to provide HomeAdvisor with certain mortgage underwriting and valuation technologies and related services for redistribution to mortgage lenders that subscribe to HomeAdvisor's products and services. This is an arms-length agreement under which Freddie Mac is being compensated for providing our technologies. You should be assured, however, that Freddie Mac does not have an equity investment in HomeAdvisor. In fact, the agreement expressly prohibits Freddie Mac from *ever* owning voting securities or any other type of equity security in HomeAdvisor.

As part of this agreement, Freddie Mac is also purchasing subordinated debt of HomeAdvisor, which Home Advisor has an unconditional obligation to repay. Because it is a startup, we have agreed to accept interest on this debt from HomeAdvisor in the form

of warrants. But these warrants will be restricted: Freddie Mac will *never* be permitted to exercise the warrants to own stock; instead, we may realize the value associated with the warrants only by selling the warrants to third parties.

This type of financing – subordinated debt with interest in the form of warrants – is clearly not an equity investment, even under the federal banking laws. That is, a national bank, which is expressly prohibited from making equity investments, is permitted to make loans in which interest is paid in the form of warrants, so long as the bank has no authority to exercise such warrants. 12 C.F.R. § 7.1006.

We believe that this relationship with HomeAdvisor – a company whose purpose will be to promote the efficiency of the residential mortgage market -- is well within our charter powers. Indeed, our collaborative agreement with HomeAdvisor Technologies is aimed at promoting increased access to low-cost mortgage credit nationwide. This and similar innovations that will bring the speed and accuracy of on-line systems to lenders and consumers has the potential to save a family thousands of dollars in buying a home. Ultimately, consumers will benefit from lower origination costs and a faster, more efficient mortgage process.

Again, I thank you for your interest in our collaboration with HomeAdvisor Technologies Inc. and am happy to discuss any further questions you may have.

Sincerely,

Mitchell Delk
Senior Vice President—Government Relations

STATEMENT OF
ALEX J. POLLOCK
PRESIDENT AND CHIEF EXECUTIVE OFFICER
FEDERAL HOME LOAN BANK OF CHICAGO

TO THE
SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES AND GOVERNMENT SPONSORED ENTERPRISES

OF THE
COMMITTEE ON BANKING AND FINANCIAL SERVICES

OF THE
U.S. HOUSE OF REPRESENTATIVES

REGARDING
H.R. 3703
THE HOUSING FINANCE REGULATORY IMPROVEMENT ACT OF 2000

MAY 16, 2000

The Federal Home Loan Bank of Chicago sincerely appreciates Chairman Baker's invitation to present our written testimony on H.R. 3703 and related issues.

We agree with the goal of improving the regulatory structure of the three housing GSEs, but wish to suggest that enhancing competition should be the guiding principle.

As many members of the subcommittee are aware, the Chicago Home Loan Bank has for years advocated the view that the best way for Congress to insure that GSE charter advantages are passed through to local mortgage lending and homeownership, is to encourage competition among the three housing GSEs. Our positions on this bill and any legislative proposal affecting the Federal Home Loan Bank System reflect this perspective. We believe the market forces of competition and innovation are the best disciplines for all enterprises, including GSEs. We also recognize that, due to their special advantages, the only viable competitor for a GSE is another GSE.

The Mortgage Partnership Finance® Program, which was developed by the Chicago Home Loan Bank and in which ten of the twelve Home Loan Banks currently participate, is putting these concepts into practice. MPF® adds much-needed competition to the secondary mortgage market to benefit our local financial institution members and their homebuying customers. The

innovative risk sharing structure of the MPF Program also disperses the credit risk of mortgages among the hundreds of participating lenders, rather than concentrating them in the GSEs.

We believe the proper purpose of H.R. 3703 would be to create a level regulatory environment for the three housing GSEs, in order to promote competition among the GSEs and increase the benefits to community lenders and homebuyers. As the co-sponsors recognize, the current structure of three Federal agencies regulating various aspects of three GSEs is redundant and leads to disparate regulations, capital requirements and regulatory burdens. We propose giving housing GSEs a common set of regulatory principles along with a consistent regulatory structure. This will benefit the American mortgage system and the participants in the housing finance process.

With these principles in mind, we recommend any housing GSE legislation include the following key provisions.

1. Definition of Mission

In our judgment, Congress should not delegate the definition of the mission of a GSE to a regulatory body, which we believe would put far too much discretion into the hands of unelected officials. Thus a common mission statement is needed in the bill. This statement, in our opinion, should be: "The mission of the three housing GSEs is to promote sound, economical and readily available home mortgage finance throughout America by creating wholesale, capital market-based financing opportunities for mortgage lenders."

2. Statement of Intent to Promote Competition

We also recommend that the bill include a statement declaring the intention of the Congress to promote competition by treating all three housing GSEs as equally as practicable for regulatory and supervisory purposes. While the goal should be to create a level playing field for GSEs, the structure of H.R. 3703 appears to contradict this by treating Fannie Mae and Freddie Mac one way, then treating the Federal Home Loan Banks in a different way, in most of the provisions. The identical language should apply to the greatest extent practicable to all three GSEs and the regulatory agency should be directed to have its actions reflect this principle.

3. Role of the Regulatory Agency

H.R. 3703 gives the "chief executive officer" (we would recommend a normal title of "director" or "chairman") of the newly created regulatory agency broad, undefined discretionary powers. The function of any regulator, including a GSE regulator, should be clearly limited and defined, in this case, to regulate safety and soundness of three GSEs and approve new programs consistent with their mission as defined by Congress.

4. Leverage and Risk-Based Capital Ratios

Today, Fannie Mae and Freddie Mac have a competitive advantage because of their lower capital requirements, which do however more closely reflect true economic risks of mortgages than FHLB or depository institution capital standards do. The FHLB Modernization Act, enacted last fall as part of the Gramm-Leach-Bliley Act, establishes a leverage floor of 4% for the Home Loan Banks while Fannie Mae and Freddie Mac are allowed a 2.5% capital to assets ratio. A level regulatory field should include the same required leverage capital ratios for all three GSEs.

The different regulatory treatment for Freddie Mac and Fannie Mae, on the one hand, and for the Home Loan Banks on the other, contained in H.R. 3703 is also problematic in risk-based capital requirements. Different risk-based capital requirements structurally advantage one or the other GSE competitor. We recommend that the risk-based capital requirements for the GSEs be based on the same economically correct risk-based factors, so that among all three GSEs, equivalent risks give rise to the same risk-based capital requirements.

To have one regulator applying two different risk-based capital standards to the same risk would certainly be an anomalous situation and seems to us inconsistent with the basic concept of the bill.

5. Permanent Capital

During the consideration of the Gramm-Leach-Bliley Act last year, the Chicago Home Loan Bank consistently proposed giving the FHLBs the authority to create non-redeemable, permanent capital. True permanent capital is particularly appropriate now that all membership in the FHLB System is voluntary. The Chicago Home Loan Bank continues to believe that permanent capital and equal capital standards should apply to all three GSEs.

6. Innovation

The three housing GSEs should be encouraged to create innovative programs, consistent with their high credit quality, which profitably serve their housing finance missions. Currently, Fannie Mae and Freddie Mac have such innovation authority in statute, while the FHLBs do not. We suggest that the ability to innovate in H.R. 3703 be identical for all three GSEs.

7. Director Appointments

Currently, all three housing GSEs have appointed directors on the boards. The President of the United States chooses the appointed directors in the case of Fannie Mae and Freddie Mac, while the Federal Housing Finance Board chooses the appointed directors for the Federal Home Loan Banks. A single regulator for all three GSEs should clearly not be appointing directors to

one of its three regulated entities, as would be a result of the bill. The provisions for appointed directors of the three GSEs need to be consistent.

8. Tax Status

Currently, Fannie Mae and Freddie Mac are subject to federal corporate income taxes. The Home Loan Banks do not pay federal income taxes, but instead pay the Resolution Funding Corporation (REFCorp) obligation and statutorily mandated Affordable Housing Program contributions, which result in a de facto high rate of taxation. We recommend that the bill make the REFCorp obligation and the mandated AHP expenses tax credits, while applying federal corporate income taxes to the FHLBs. This would make FHLB taxation equivalent to the other housing GSEs.

Thank you for the opportunity to present our written testimony. We would be happy to provide any information or additional comments which would be helpful to the subcommittee.

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